11 Supply chain and vertical issues

11.1 Introduction

The first 10 chapters of this report focused on horizontal competition at the retail level. The remainder of the report focuses on supply chain issues and their impact on retail prices.

Supply chain issues are relevant to the inquiry for three reasons:

- if there is a lack of horizontal competition at any level of the supply chain, this weakness will flow through to consumers in the form of higher prices
- if changes in prices at one level of the supply chain, are not reflective of higher costs, this could reflect market power at that level of the supply chain
- buyer power in the supply chain can damage efficiency, by eroding investment and innovation in the upstream markets, resulting in a less competitive supply chain overall.

To explore the first issue, it is necessary to examine some features of the various supply chains through which groceries pass. Issues such as the number of participants, the market share of those participants, how prices are set and the outside options available to participants are all relevant when considering whether there is effective competition throughout the supply chain. However, in the timeframe available the ACCC has not been able to investigate the potential market power of every manufacturer, processor and wholesaler for the many thousands of standard groceries. Accordingly, only a selection has been examined in detail in the next chapter.

To explore the second issue, it is necessary to consider the relationship between prices in the supply chain, particularly the gap between wholesale and retail prices. The key question to be answered is: When retailers increase retail prices, is it because they are facing higher wholesale prices (which, assuming effective competition elsewhere in the supply chain, reflect higher commodity prices, climate shocks and increased production costs), or are they raising prices even in the absence of such changes to their costs?[1]

To explore the third issue, it is necessary to consider whether any party in the supply chain has buyer power and, if so, whether they are exercising it in such a way that it damages the long term efficiency of the supply chain. In particular, the focus in this inquiry report is on the buyer power of the MSCs and Metcash.

The brief general introduction to the supply chain contained in this chapter is followed in chapter 12 by eight case studies, which provide a detailed analysis of the competitiveness of the supply chains for a selection of standard grocery items. A broader discussion of the gap between farm gate and retail prices occurs in chapter 13. The report then considers issues concerning buyer and bargaining power. Chapter 14 provides a theoretical framework for considering buyer and bargaining power and chapter 15 considers evidence provided to the inquiry about buyer and bargaining power, including an analysis of trading terms. The issue of private label products, which is also related to buyer power, is specifically considered in chapter 16. Chapter 17 outlines the main conclusions on supply chain issues. Finally, chapter 18 considers whether changes to the Horticulture Code are necessary to improve vertical relationships in the horticulture supply chain.

1 Assuming no change in the retailers' costs of doing business.

11.1.1 Assessment of the efficiency of the supply chain

The efficiency of a particular supply chain depends on the nature and extent of horizontal competition at each functional level of the supply chain as well as the vertical relationships between different levels in the supply chain. Those vertical relationships may, in turn, impact on horizontal competition throughout the supply chain. In assessing the efficiency of the supply chain, the ACCC has therefore examined the horizontal competition at the various functional levels as well as the vertical relationships between parties in different functional levels. This assessment has been facilitated by information obtained by the ACCC using its information gathering powers. Much of this information was provided in confidence.

The ACCC considers that concerns about potential impediments to the efficient supply of groceries to consumers are only likely to be realised if market power exists in any of the functional levels of the supply chain. Market power is more likely to exist where there are high barriers to entry, high levels of concentration and limited import competition. In the absence of market power, the ACCC is confident that the supply chain would deliver groceries to consumers in an efficient manner, which would result in greater choice and lower prices for consumers.

This assessment also applies to the potential effect of vertical relationships on the efficiency of grocery supply chains. Generally, vertical relationships or vertical integration helps to coordinate interdependent stages in the supply chain and minimise the transaction costs of doing so, to the benefit of efficiency and consumers. However, where there is market power, some vertical arrangements, typically known as vertical restraints, can have anti-competitive effects by raising barriers to entry or by foreclosing actual and potential competitors.

In examining the nature of relationships between the various vertical layers of the supply chain, the ACCC has considered the extent to which any aspects of those relationships unnecessarily constrain each party involved in a way that may be anti-competitive.

The next section of this chapter looks briefly at some of the major supply chains for standard groceries. Due to the vast range of supply chains, this section necessarily provides a broad introduction only. More detailed analysis of individual supply chains is undertaken in the case studies presented in chapter 12.

11.2 Introduction to the supply chain

During this inquiry it has become evident that the supply chains for each grocery category vary considerably. For fresh produce there is typically a short supply chain, that mostly comprises three functional levels— produce is purchased at the farm gate by a wholesaler and is then on-sold to retailers. For some fresh produce, such as dairy and meat, more complex processing occurs after the farm gate and before wholesaling, resulting in a four-level supply chain.

For the MSCs, ALDI and Franklins, the wholesale function is primarily performed in-house by the retailer. For most other grocery retailers and specialty stores, the wholesale function is performed by wholesalers and consolidators for fresh produce and by Metcash for packaged groceries.

Fruit and vegetables

The supply chain for fruit and vegetables is varied.

It is estimated that there are more than 2800 commercial vegetable production enterprises around

Australia.[2] The majority of vegetable growers are small in terms of the area they crop and most focus only on a single vegetable crop.[3] Similarly, fruit production also involves large numbers of small-sized participants spread throughout Australia.

Australia's varying climate and soil conditions mean that different regions are amenable to producing different ranges of fruits and vegetables. Given the geographical size of the country, this creates a need for significant transportation of fresh produce to ensure continuous fresh supply. Similarly, Australia's varied climate means fruit and vegetable produce grown in different regions will become available at different times of year. To counteract deterioration of fresh produce, farmers, and in some cases processors, may chill the produce immediately after harvest or use controlled atmosphere storage (with lower levels of oxygen and higher levels of carbon dioxide than normal air) to further slow deterioration.[4] This enables crops that would otherwise be more susceptible to seasonal fluctuations in sup`ply to be released over a longer period.

Increasingly, fruit and vegetable growers are by-passing wholesalers and entering into direct supply arrangements with the major supermarket chains (MSCs) and other retail outlets. The ACCC understands that the majority of fruit and vegetables sold in the MSCs and ALDI do not pass through a wholesaler. It is estimated that only 20 to 30 per cent of MSC produce is now purchased from wholesalers.

The ACCC understands that most fruit and vegetables sold in independent stores are supplied by wholesalers (typically this is not Metcash, although, as discussed in chapter 7, Metcash has commenced wholesaling fresh produce through IGA Fresh.[5])

Restaurants also usually obtain their fresh produce through wholesalers or providores. Wholesalers and providores may also be used to source product to some extent by some processors and exporters.

The majority of wholesalers operate from the central wholesale markets located in Melbourne, Sydney, Brisbane, Adelaide and Perth.

Not all farm produce consumed as food goes through wholesale markets or is sold to MSCs. Large quantities are sold directly to manufacturers and processors of various kinds. Processing of fruit and vegetables predominantly consists of manufacturing fruit and vegetable juices, or canning, preserving, freezing or drying produce. Fruit and vegetables are also key inputs into many products such as sauces, jams, prepared meals and snacks. Certain products, such as potatoes, often tend to be used in processing. For example in 2004, 56 per cent of the domestic potato crop was sold as processed potatoes[6]. Domestic processors, particularly in the case of processed potato products, generally compete for sales with imported processed products. Processors are also able to export some of their products.

In addition to imported and exported processed produce, there are also significant quantities of fresh fruit and vegetables being imported and exported. The main export products include fresh carrots, asparagus, onions, cauliflower, potatoes, oranges, grapes and apples.[7] Exporters either contract directly with farmers or purchase from wholesalers in wholesale markets. Imports of fresh product are typically most significant during domestic off-seasons or periods of domestic shortage. Although levels of imports have increased recently, a wide range of fresh produce is prohibited from entering Australia

2 Australian Bureau of Agricultural and Resource Economics (ABARE) research report, *Australian Vegetable Growing*, October 2007, p. 1.

3 ibid., p. 7.

4 Coles, 'Public submission to the grocery inquiry', 28 March 2008, p. 67.

5 ACCC, public hearing, Melbourne, 2 June 2008, p. 66.

6 AusVeg, *Australian Processing Potato Industry Strategic Plan 2006-2011,* November 2006, 9

7 Austrade, *Fruit and Vegetable overview*, accessed on 23 April 2008 at www.austrade.gov.au/Fruit-and-vegetables/default.aspx.

because of strict quarantine restrictions. Fresh imports are typically sold directly to the MSCs or to independent retailers through the wholesale markets. Oranges and pineapples are two of the fruits most commonly imported into Australia.[8]

There were no concerns raised by wholesalers or retailers about producers overpricing their fresh fruit and vegetable produce at the farm gate. The markets in every commodity appear to be characterised by a large number of producers and low barriers to entry. Farming and agricultural groups accepted that farmers, growers and graziers were essentially price takers. Prices are dictated by supply-and-demand conditions in the marketplace at the time the growers' products are ready for market. The ACCC has no concerns about the competitiveness of any market at this level.

At the wholesale level the market narrowed considerably. For some commodities, such as potatoes, there were significantly fewer packers and wholesalers than growers. However, notwithstanding that the markets were more concentrated at the wholesale level in most commodities, there were a number of different routes to market that a grower could access and a number of market alternatives for a person looking to acquire product.

For a grower, selling produce through one of the wholesale markets in a capital city represents a relatively straightforward route to market. The ACCC understands that for a supplier to sell produce through some markets, they require a relationship with a wholesaler, but in other markets, such as Adelaide, a growers' shed is available that allows growers to deal directly with wholesale customers.

The wholesale market appears to operate efficiently. Prices in the wholesale market appear to be set by supply and demand. Complaints about the operation of these markets were primarily directed at their perceived lack of transparency when a grower dealt with a wholesaler. These issues are examined more closely in chapter 18, which deals with the Horticulture Code.

In addition to selling through the wholesale markets, growers can also:

- sell direct to an MSC
- establish a direct relationship with a larger group of independent stores
- supply processors
- export
- develop their own direct retailing arrangements
- vertically integrate to further process their own product.

While the availability of these options will vary with the growers' particular circumstances, in the course of the inquiry the ACCC has seen examples of all of these kinds of arrangements.

As noted in chapter 3, the ACCC has found that up to 50 per cent of fruit and vegetables at the retail level are sold through an MSC. While the ACCC notes that this is a relatively large percentage of the fruit and vegetables sold at retail level, in terms of the wider market for farm produce (when food service, processors and export are considered) the MSCs represent a much smaller proportion of the potential buyers of farm produce.

Accordingly, the ACCC is satisfied that, broadly speaking, the wholesale level of the market for produce was efficient and competitive with a depth and variety of market participants to allow prices to be set by market forces.

In chapter 12, the apples case study provides more detail for a single product.

8 IBISWorld, *Fruit growing in Australia*, A0119, 29 June 2007, p. 14.

Milk and dairy[9]

The typical supermarket dairy cabinet holds a range of standard groceries. It is estimated that of the raw milk supplied by farms in Australia:

- 35 per cent is used in cheese production
- 23 per cent is used for drinking milk
- 23 per cent is made into skim milk powder and/or butter
- 11 per cent becomes white milk powder
- 3 per cent becomes casein and/or butter
- 5 per cent is used for other purposes.

There are approximately 8000 dairy farms in Australia, most located in Victoria.

The supply chain is generally relatively simple, with the dairy farmer supplying raw milk to dairy manufacturers, who, after processing, supply the MSCs, Metcash, other retail stores and export markets. Approximately 50 per cent of milk produced domestically is converted into products that are exported (constituting around 12 per cent of world dairy trade). Around 68 per cent of manufactured dairy product produced in Australia is exported, compared to only 4 per cent of drinking milk. Small quantities of dairy products are also imported, primarily from New Zealand.

When supplying Australian retail stores, dairy manufacturers generally use a mix of delivery direct to store and delivery to wholesale distribution centres, depending on the product (largely upon its shelf life).

No concerns were raised during the inquiry that the farm gate market is not competitive. The large number of milk producers across diverse geographical regions means that the milk processors have a large number of potential suppliers and the market appears to respond to price signals, with milk production falling in response to low farm gate pricing.

Concerns were, however, raised that the market for the acquisition of milk from farmers by processors was not always so competitive. For example, allegations of ‘no poach’ agreements were made in respect of processors in north-west New South Wales.

The ACCC is satisfied that the market for the acquisition of milk from the farm gate is competitive and price is set by market forces of supply and demand. As discussed later in chapter 12, because milk products are internationally traded, the prices domestic milk processors offer are primarily set by international factors. The best evidence of this was the recent surge in farm gate price in response to rising international demand. Accordingly the ACCC considers that the market for fresh milk at the farm gate is competitive.

The other level of the dairy supply chain is the supply of dairy products by the processors to retailers. As a number of processors can supply milk, cheese, cream, yoghurt and other dairy products, and there is strong competition for access to retail shelf space, the ACCC is satisfied that the market at this level is broadly competitive.

Meat and poultry

The supply chains for red meat and poultry are varied and often complex. Rather than explore all of the specifics in this chapter, much of the detail is covered in the context of two case studies, beef and chicken, in chapter 12.

9 The information in this section is sourced from Dairy Australia, *Australian dairy industry in focus 2007*.

Red meat

The supply chains for red meat including beef and lamb are broadly similar. Farmers rear animals until they reach the preferred specifications of the relevant market.

Like other primary producers, there are a large number of sellers at this level but significantly fewer participants at the wholesale level. Accordingly, the market for wholesale supply is considered to be highly competitive, with graziers being price takers. The inquiry was presented with good evidence that prevailing beef prices in the Western Australian domestic market were not sufficient to cover the costs of raising animals.

Compared to producers of fresh produce, meat producers have relatively few alternatives available to them to sell their product onto the domestic market. Although several avenues for sale of livestock are available, sales occur primarily through saleyards or directly to feedlots, processors or retailers. The methods used to calculate payment vary and are detailed further in chapter 12.

The supply chain for meat sold domestically by retailers may include some or all of the following steps:

- purchase of animal→finishing on feedlots→transportation→slaughter and boning→further processing and packing→transportation to distribution centres/stores→in-store butchery preparation→packaging→shelves.

Issues explored in detail in the chapter 12 beef case study include the ability for grazier's to export as an alternative to dealing with domestic purchasers, and the explanations for poor beef prices.

Pork

There are approximately 1900 pork producers in Australia.[10] The pork supply chain is not examined in detail in a case study in chapter 12, so supply chain issues are considered in some detail below.

Locally produced pigmeat is either sold in the fresh pork market or used in the manufacture of bacon, ham and smallgoods. Porker pigs typically supply fresh pork and larger, baconer pigs supply the processed pork market; however, subject to size constraints[11], cuts from either type of pig can be sold to both markets. The market to which the meat is sold generally depends on the relative prices for pigmeat in the fresh and processed markets.

The route the pigmeat follows through the supply chain depends on whether it is intended for the fresh or processed market. Porker pigs are typically sold under contract to big retailers or wholesalers through longstanding arrangements; however, around 5 per cent of pigs are also sold through the saleyard.[12] Abattoirs perform 'service kills' for the purchaser of the pig. Retailers then sell the meat under private brands and wholesalers will then prepare the meat for sale in supermarkets and butcheries or for export or the food service industry.

Baconer pigs follow a similar process. However, retailers, wholesalers and small good manufacturers can obtain imported pigmeat in addition to or instead of acquiring Australian carcases from abattoirs.

More than half of the pork produced in Australia is part of an 'integrated supply chain which includes primary processing and production'.[13] Australian Pork Limited (APL) submitted that

10 IBIS World*, Pig Farming in Australia*, 11 September 2007, p. 36.

11 Productivity Commission, *Pig and pigmeat industries: safeguard action against imports*, 1999, p. 55 available at www.pc.gov.au/__data/assets/pdf_file/0006/41595/pigs.pdf.

12 APL, submission no. 147, p. 6.

13 APL, submission no. 147, p. 6.

> … of the 5 million pigs slaughtered (each year) some 3 million are part of an integrated enterprise including production and primary processing, the remaining pigs sold for slaughter are sourced either through saleyards, spot-market or forward and general contracts.[14]

Australia is a net importer of pigmeat.[15] Since 1990, imports of boned, frozen cuts of pigmeat have been allowed into Australia from certain countries (including Canada and New Zealand). As a result of the fact that pigmeat is an internationally traded commodity, domestic prices have largely been linked to world prices for both the fresh and processed pork markets. The link between the world price and domestic prices for both fresh and processed pork has strengthened as the range of imported cuts has expanded.[16]

As stated by the Productivity Commission:

> The opening of the market to imported cuts has essentially capped prices for equivalent locally-produced cuts at world prices.[17]

Even though the fresh pork and bone-in processed market is not subject to direct import competition, the availability of imported cuts (or a decrease in the import price) encourages domestic producers to switch supply from the processing market to the fresh meat or bone-in processed markets, depressing prices in those markets to the point that producer returns are eventually equalised across baconer and porker markets.[18]

Submissions from pig producers and industry bodies suggest that producers are not able to achieve prices that cover their production costs.

Given the number of producers and the level of import competition, the ACCC is satisfied that this level of the supply chain is highly competitive.

At the wholesale level, wholesalers and processors are subject to direct competition from vertically integrated MSCs. Accordingly, the ability of wholesalers and processors to raise prices is constrained by the MSC's ability to increase supply from their own supply chains. While prices achieved by producers may be below their costs of production, the ACCC is satisfied that this has not been caused by any buyer power at the wholesale level. Rather, this has occurred as a result of international supply and demand factors together with the rising Australian dollar.

At the retail level, bacon and ham prices have declined in real terms since 1992, which probably reflects the exposure to imports from overseas. Pork prices have been above the CPI since 1992 but in the last two years price increases have been well below the CPI. Given this movement in retail prices, the ACCC is satisfied that pork and processed pork supply chains are competitive.

Chicken

The chicken meat supply chain differs slightly from that for red meat because the industry operates largely through vertical integration with company ownership of breeding farms, multiplication farms, hatcheries, feed mills, some broiler[19] growing farms and processing plants. Integrated processors supply day-old chicks and feed to contract growers or company-owned farms. They then collect the

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14 APL, submission no. 1 to Productivity Commission, *Safeguards inquiry into the import of pigmeat*, 23 November 2007, p. 34.

15 Productivity Commission, *Safeguards inquiry into the import of pigmeat—Productivity Commission inquiry report*, 2008, p. 17 available at www.pc.gov.au/__data/assets/pdf_file/0004/78457/pigmeatsafeguards.pdf.

16 Productivity Commission, *Safeguards inquiry into the import of pigmeat—Productivity Commission inquiry report*, 2008, p. 16 available at www.pc.gov.au/__data/assets/pdf_file/0004/78457/pigmeatsafeguards.pdf.

17 Productivity Commission, *Safeguards inquiry into the import of pigmeat—Productivity Commission inquiry report*, 2008, p. 17 available at www.pc.gov.au/__data/assets/pdf_file/0004/78457/pigmeatsafeguards.pdf.

18 ibid., p. 32.

19 'Broiler' is the industry term for a chicken reared for meat production.

grown chicks, perform the necessary processing and then distribute and market the meat primarily to the retailing sector and the fast food industry.

As discussed in the chicken case study in chapter 12, some growers have been able to obtain a degree of countervailing power in negotiations with processors through collective bargaining. However, not all growers have been successful in engaging in collective negotiations. An industry participant confidentially submitted that fees paid to growers have not kept pace with the increase in growers' costs. Such an outcome is consistent with the assertion that growers are often in a weak bargaining position in their negotiations with processors. Overall, given that the cost of chicken has declined in real terms over the last 15 years, the ACCC is satisfied that the supply chain is generally efficient and competitive.

Dry groceries

The supply chain for dry groceries is largely a supply chain for manufactured products. Dry groceries are produced by manufacturers who then generally negotiate directly with the MSCs or Metcash to have their product ranged.

Inputs for manufactured products depend largely upon the product examined. Many manufacturers have in recent times had to contend with large cost increases in their inputs, including rising costs of flour (associated with the rise in wheat) and skim milk powder. The ACCC is satisfied such input prices are generally driven by international commodity prices rather than any exercise of market power at that level of the supply chain. Accordingly, it is unlikely there is a competition issue at that level of supply, although in the context of this inquiry it is impossible to analyse the market for every input into the many thousands of products that are standard groceries.

For a food or non-food manufacturer to get broad distribution of its product through retail supermarkets in Australia, it is necessary to persuade the MSCs or Metcash to range the product or obtain a direct supply contract with ALDI. Ranging decisions for the MSCs are generally made as part of category reviews. These reviews essentially facilitate competition between the suppliers of dry groceries. The MSCs are looking for products that deliver margins and volumes which are attractive to them, while still providing a full range of products that consumers look for in a supermarket. In seeking to obtain access to scarce retail shelf space, it is necessary for manufacturers to consider competition from other manufacturers of products within the category (including private label products), the returns its product is likely to generate for the MSC and whether the product is sufficiently well known with sufficient brand loyalty to require the MSC to stock the product. Details regarding negotiations for shelf space are discussed in chapter 15. Some direct supply arrangements with independents are possible, but for the most common dry groceries, that is not the usual means of distribution.

The ACCC considers that the retail level of the supply chain for dry groceries is more likely to suffer from a lack of competition than other levels of the supply chain. The ACCC is unable to rule out that some products may be insulated from strong competition at various points in the supply chain because of high barriers to entry, the strength of branding and/or high market concentration. However, the vast bulk of grocery products are exposed to a number of competitive pressures, including inter-brand competition and competition for limited shelf space, which generally constrain the price at which manufacturers are able to sell their product.

Other products

A huge range of foods available in supermarkets have not been discussed above. Typically, most fresh foods have a fairly similar supply chain, with the farmer supplying either directly, or indirectly via a wholesaler or a processor, to a manufacturer. The manufacturer will then deliver the product to the retailers' or Metcash's distribution centres, from where it is transported to the individual retail stores.

There are many exceptions—for example, bread is generally supplied directly by wholesale bakeries to the stores (rather than via the retailers' distribution centres) or, alternatively, bread may be baked and prepared in-store by in-store bakeries. The bread supply chain is discussed in greater detail in the relevant case study in chapter 12.

Non-food items

For non-food standard grocery items—such as oral and personal care items, hair products, baby needs, cleaning and pest control products, foils and wraps and pet foods[20]—the supply chain is generally relatively simple and almost identical to that for dry grocery items.

Non-food items are often high-value non-perishable items, which are capable of being transported greater distances than many food items. Accordingly, imported non-food items compete with domestically produced non-food items in many categories. Some of the larger suppliers of non-food items to Australian supermarkets include Unilever, Kimberly-Clark and Colgate Palmolive.[21]

Similarly to dry grocery products, inter-brand competition as well as competition for access to retail space exists. This assists in putting downward pressure on the prices that can be set by manufacturers, as are the introduction of greater numbers of private label products.

11.3 Conclusions

This chapter has introduced some key issues that will be the focus of much of the remainder of the report, and briefly described several key supply chains and factors that influence market power in the supply chain.

During the inquiry the ACCC obtained information about the workings of supply chains, which provide indicators on the efficiency and competitiveness of those supply chains. Generally speaking, on the information available to the ACCC, the supply chains have characteristics consistent with them being efficient and competitive markets.

The ACCC considers that competition and efficiency concerns are only likely if horizontal competition is weak at any of the vertical stages, resulting in sellers having market power at that stage. The ACCC has received little firm evidence of such a situation prevailing at any level below the retail level, but has not been able to investigate all market participants involved with the supply chains for the thousands of standard grocery products.

Competition concerns may also arise if buyers have power on the demand side of the market. Thus, the ACCC's assessment of the supply chain involves an examination of the vertical relationships that exist between buyers and sellers, particularly between growers/suppliers and retailers/wholesalers (see chapters 14 and 15).

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20 Although the precise definition of standard groceries is not critical, for the purposes of this inquiry, as discussed earlier, the ACCC has excluded items such as cigarettes, kitchenware, hardware and stationery (even though many of these products can be purchased in supermarkets).

21 Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2007*, Retail Media, Sydney, 2007, pp. 17–18.

12 Cost contributors in the supply chain

The ACCC has been asked to consider all aspects of supply chains in the grocery industry in this inquiry, including the nature of competition at the supply, wholesale and retail levels.

The ACCC could not investigate in detail supply chains for all relevant grocery items in preparing this report. Accordingly, the ACCC has undertaken case studies of cost contributors in the supply chain for a number of standard grocery items:

- white full-cream drinking milk
- chicken
- apples
- bread
- eggs
- nappies
- biscuits
- beef.

The case studies are based on information available in public reports, information about each of the supply chains provided in the course of the inquiry through submissions, at hearings and in response to s. 95ZK notices and the ACCC's own inquiries.

Some of the information provided in submissions and at hearings, and much of the information provided in response to s. 95ZK notices, was commercially sensitive and has not been publicly disclosed by the ACCC. Such information included details of cost structures, contract negotiations, contract terms and conditions and supply costs and prices at various stages of supply chains. While the ACCC has relied on this information in preparing these cases studies, commercially sensitive information is only referred to in general terms and reported in broad aggregates in this report.

The case studies include analysis of farm gate, wholesale and retail prices as well as examination of input costs and gross returns to each level of the supply chain. Information used to conduct this analysis was sourced from a number of retailers and numerous suppliers. Accordingly, except where specific reference is made to an individual company, no conclusions should be drawn from these case studies about any individual companies prices, costs or gross returns over the periods reported.

12.1 Drinking milk

Key points

- The retail price of milk has increased at a significantly faster rate than CPI over the last five years. However, the rate of increase in the price of private label milk sold through supermarkets, which makes up 55 per cent of all supermarket milk sales, has been significantly below CPI.
- The farm gate price of raw milk, which makes up between 25 per cent and 44 per cent of the end retail price, has increased by upwards of 40 per cent in the last 12 months. The farm gate prices as a proportion of the retail price of milk has also increased.
- There is strong competition at the processor level for the supply of both branded and private label milk.
- Increases in production costs are generally reflected in the retail price of branded milk.
- The bargaining power of the major supermarket chains (MSCs) means that increases in production costs are not being fully reflected in the wholesale or retail price of private label milk.
- The dairy milk supply chain has three distinct levels:
    - the dairy farm
    - the dairy processor
    - the retailer.
- This case study examines cost, price and margin in the supply chain for drinking milk with a particular focus on white, full-cream drinking milk.

12.1.1 Dairy farming and farm gate prices

The farm gate price of raw milk is a key determinant of the retail price for white drinking milk paid by consumers at the checkout. While the farm gate price as a proportion of the end retail price for white milk varies by product, processor and across time, currently the farm gate price as a percentage of the retail price of white full-cream drinking milk sold through the MSCs generally ranges from around 25 per cent to 44 per cent.[1]

Dairy farming[2]

Milk production in Australia is typically seasonal, peaking at around 1200 million litres in October with a low of 600 million litres produced in May and June. Seasonality of milk production is greatest in south-eastern Australia, where a greater proportion of milk produced is used for manufactured dairy products. Production is less cyclical in other states where more milk production is directed towards fresh drinking milk for consumption in the local area.

Approximately 50 per cent of Australia's 2006–07 milk production was exported, after processing, at an estimated value of $2.5 billion, accounting for around 12 per cent of world dairy trade.

Domestically, per capita consumption of drinking milk in 2006–07 was 104 litres and approximately 2 billion litres in total was consumed. This represents around 20 per cent of annual domestic production. A further 30 per cent of domestic production was consumed domestically through products such as cheese, dairy spreads and yogurt, taking total per capita milk equivalent consumption to approximately 295 litres.

1 Based on a farm gate price of 48.5 cents per litre and a retail price for a two litre carton, ranging from $2.20 to $3.80.

2 Unless otherwise noted the information in this section is taken from Dairy Australia, *Australian dairy industry in focus 2007*, 2007.

Total domestic raw milk production in 2006–07 declined 5 per cent from 2005–06, attributed primarily to the effects of drought. Dairy Australia forecasts suggest a further 5 per cent drop in production in 2007–08.[3] Dairy Australia forecasts production to remain steady or increase slightly in 2008–09.[4]

Dairy farming—trends in key input costs

Costs for a number of key farm inputs in the production of raw milk have increased significantly in recent years. National Foods submitted that domestic drought conditions have had the dual effect of increasing the cost of raw milk production for dairy processors and reducing milk supply to processors. Specifically, National Foods noted that scarcity of water, particularly in irrigation-dependent areas, has resulted in substantially higher input costs for farmers, who have needed to either pay higher prices for water or feed their herds on higher cost grain and hay.[5]

Fonterra noted in its submission that this has occurred at a time when other key costs, such as fuel, feed, fertiliser and labour have also risen dramatically.[6]

In evidence given at a hearing Parmalat stated that internal analysis it had undertaken examining feed costs and variable production costs for dairy farmers indicated that, from a base cost index of 1 in 2000, costs had risen to 1.53 in 2006–07 and 1.77 in 2007–08.[7]

The role of international dairy prices in setting domestic farm gate prices

Australian dairy farmers operate in a deregulated and open market. Consequently, international prices are a major factor determining the price received by farmers for their milk.[8] In particular, farm gate prices paid to farmers in the south-east of Australia are heavily influenced by world dairy commodity prices.

With around 50 per cent of domestic raw milk production being exported (after processing), primarily in the form of milk powders and cheese, processors of dairy products to satisfy domestic demand compete directly for raw milk with production aimed at export markets. Accordingly, processors of product for domestic markets are required to match world dairy prices to ensure supply.

Fonterra's submission to the inquiry noted that:

> While domestic demand for dairy products has shown solid growth in Australia, international demand has reached unprecedented levels. This accelerating international demand has been driven by a range of cultural and economic factors, including the significant economic growth and cultural change of a number of evolving markets such as China and other Asian countries. In addition the global stockpiles of the key dairy commodities traditionally held by the European Union and the United States have been eroded to the extent that in May 2007 they had been effectively emptied.
>
> As demand for dairy products has accelerated many of the traditional exporters of dairy products have been unable to grow their supply to meet this increasing demand. Fuel and grain prices have reached record levels and there is increasing pressure on land use as other land use opportunities, such as bio fuels production, compete for lands traditionally used for dairy production.[9]

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3 Dairy Australia, *Dairy 2008: situation and outlook*, 2008, p. 49.

4 ibid, p. 55.

5 National Foods, submission 133, p. 2.

6 Fonterra, submission 85, p. 4.

7 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 49.

8 Dairy Australia, *Australian dairy industry in focus 2007*, 2007, p. 10.

9 Fonterra, submission 85, p. 4.

The Australian Bureau of Agricultural and Resource Economics (ABARE) reports that this resulted in sharp rises in world prices for major dairy products in 2007–08.[10] This growth was on the back of steady growth in world prices over the recent past.

ABARE estimates that global demand for dairy products is expected to grow steadily over the next five years, but that from around 2010–11 growth in production in major exporting countries is forecast to exceed growth in world import demand, which is expected to put downward pressure on prices.[11]

Influences on farm gate prices outside of south—eastern Australia

Farm gate prices are generally higher outside of the export region of south-eastern Australia. Prices in these other regions are influenced primarily by local supply and demand conditions.

For example, Parmalat noted in evidence provided at a hearing that while production in regions other than south-eastern Australia is more costly, primarily because of the need for a flat pattern of milk flow to satisfy year round demand,[12] higher prices are paid to keep production in local areas. This is because the alternative would be to source milk from other areas at a cost of the farm gate price plus transport. Parmalat noted the Victorian region farm gate price plus freight costs to Queensland sets a maximum price above which it would not be economical for it to source raw milk locally.

Notwithstanding the premium paid by processors to source raw milk locally, Parmalat noted that seasonality of production in Queensland does lead to raw milk shortages at some times of year, necessitating raw milk being transported from other regions by some processors, although not Parmalat, to satisfy local demand.[13]

More generally, as noted, farm gate prices in regions outside of south-eastern Australia will be set by local supply and demand conditions.

Trends in farm gate prices

As noted, the key determinants of farm gate prices paid to Australian dairy farmers for raw milk are:

- world dairy prices, which have increased significantly in recent years
- domestic supply conditions—domestic supply has fallen by about 10 per cent in the last two years
- dairy farmer production costs, which have also increased significantly in recent years.

As noted, farm gate prices can vary significantly by state. National average farm gate prices fell from 33 cents per litre in 2001–02 to 27.12 cents per litre in 2002–03 before gradually recovering to be approximately 33 cents per litre in 2006–07.[14]

Farm gate prices increased by upwards of 40 per cent in 2007–08 on the back of strong growth in world demand for dairy products and reduced domestic supply. Farm gate prices in 2007–08 ranged from 42 cents per litre up to 53 cents per litre and across the major production regions averaged in the range of 48 to 50 cents per litre.[15]

10 ABARE, *Australian Commodities*, March quarter, vol. 15, no. 1, 2008.

11 ibid.

12 While sufficient production to satisfy local demand is also required in south-eastern Australia even in low production months, supply far exceeds local demand.

13 ACCC public hearing transcript, Brisbane, 3 April 2008, pp. 51–52.

14 The 2001–02 to 2006–07 figures are Dairy Australia figures based on information provided by dairy manufacturers.

15 Dairy Australia, *Dairy 2008: situation and outlook*, 2008, p. 54.

Weakening export returns may lead to a fall in farm gate prices paid in south-eastern Australia of up to 10 per cent in 2008–09, which would equate to a farm gate price of 43 to 44 cents per litre. Farm gate prices in Queensland and northern New South Wales are expected to continue to rise, into the 54 to 57 cents per litre range, and prices in central New South Wales are expected to remain steady at around 46 to 49 cents per litre. Western Australian farm gate prices are expected to continue to rise from their current level of 42 to 44 cents per litre but at a slower rate than in 2007–08.[16]

While farmers in all regions have enjoyed substantial increases in farm gate prices in the last 12 to 18 months—and many are expected to receive further increases, or at least a sustained period of prices above the averages of the last few years—such increases in prices received by farmers need to be considered in the context of the significantly increased costs of production noted above.

The farmer/processor relationship

Processors source raw milk from dairy farmers for processing into drinking milk as well as for processing into other dairy products and milk powders. Processors source raw milk from dairy farmers under a variety of contractual arrangements, including through dairy cooperatives, collective negotiation with dairy farmers organised into bargaining groups[17] and individual negotiations.

Contracts are often negotiated annually, although, particularly those negotiated with cooperatives or collective bargaining groups, can range up to two to three years in duration.

Contracts generally set the fixed price, or range of prices, farmers will receive for their raw milk, subject to quality and technical specifications, such as for butter fat and protein levels. Some contracts provide for farm gate prices to be increased during the term of the agreement in line with movements in market prices. The ACCC also heard evidence at hearings that processors will on occasion, particularly in response to strong increases in market prices for raw milk, increase farm gate prices paid to farmers outside of any contractual obligation to do so. Processors indicated that they do this to ensure strong relationships with their farmers, which are necessary to remain competitive in the market for sourcing raw milk.

In most regions of Australia there are a number of processors to which farmers can supply their raw milk.

In evidence, National Foods stated:

> If you look at Northern Victoria it is probably one of the most competitive milk regions in Australia if not the world in a sense that there are a lot of processors that could pick up—and pick up farmer's milk. In New South Wales you have got National Foods, Dairy Farmers, Bega, Milk Co, Fonterra as options. In south east Queensland, National Foods, Dairy Farmers, Parmalat, Milk Co as options as in northern New South Wales. Victoria; those names, so we have got Parmalat, National Foods, Murray Goulburn, Warrnambool Cheese & Butter, Fonterra, United Dairy Power and then a range of, probably, other smaller companies as well.
>
> In Tasmania there is National Foods, Fonterra, Murray Goulburn. In South Australia you have got Warrnambool Cheese & Butter, Murray Goulburn, National Foods, Dairy Farmers, Seko, UDP. In Western Australia you have got Challenge Dairies, National Foods, Fonterra and Harvey Fresh. So in most regions there is more multiple processors to—for farmers to choose whom to supply.[18]

16 ibid.

17 See, for example, authorisations granted by the ACCC for Premium Milk Supply Pty Ltd (Premium) to collectively bargain farm gate prices and milk standards in negotiations with Pauls (A90745) and for Australian Dairy Farmers members to collectively bargain with processors (A90966). These authorisations are available from the ACCC website, www.accc.gov.au.

18 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 13.

The ACCC heard evidence at hearings that, while the incidents of dairy farmers switching between processors is not high, the capacity to do so does exist, particularly in the current climate where demand for raw milk among processors is strong. Regarding farmers switching between processors, National Foods provided evidence at a hearing that:

> You will find that you could have, in some seasons, little change and then in some other seasons, quite a lot. It's a hard percentage to put in. We do find that there is strong—strong tension processes each—annually to ensure you can secure your supply. So, it's a very competitive market out there.[19]

In contrast the Kiama Shellharbour Albion Park Milk Suppliers Collective Bargaining group contended in evidence provided at a hearing that, at least in their area, there is anecdotal evidence of an agreement between processors not to 'poach' each others farmers.[20]

To the extent that it does happen, switching generally occurs at the expiration of existing contractual arrangements. In particular, the industry generally operates on a financial year season and renegotiation of annual contracts will occur in June or July.

The ACCC has previously recognised the comparatively weak bargaining position of individual dairy farmers as compared to dairy processors.[21]

It appears, however, that more recently reduced supply of raw milk, both domestically and internationally, coupled with increasing world demand for dairy products, has resulted in increased competition among domestic dairy processors for the supply of raw milk which in turn has strengthened the bargaining position of dairy farmers.

The ACCC is satisfied that in most regions of Australia there is at present strong competition between processors for farmer's milk, as reflected in current farm gate prices. While complaints from farmers about the farm gate price they receive do persist, it is difficult to conclude on the evidence available to the inquiry that the market for the supply of raw milk for processors is not competitive.

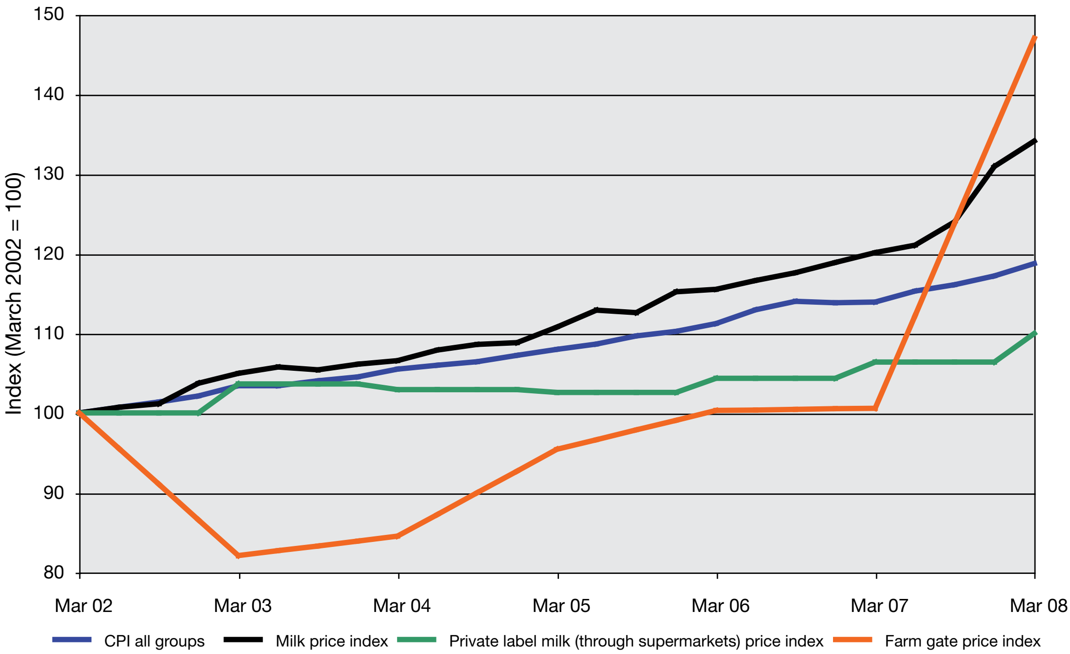
As chart 12.1 demonstrates, the farm gate price of raw milk dropped significantly in 2003–03 post deregulation. However, the rate of increase in farm gate milk prices has outpaced that of retail milk prices in recent years, meaning that farmers have received an increasing share of the retail milk price over this period. The difference between the rate of increase in farm gate and retail prices has been most pronounced over the last 12 months, reflecting the current shortage of supply that has allowed farmers to enjoy significantly higher farm gate prices. As noted previously, farms can expect to receive similar farm gate prices in the immediate future.

19 ACCC public hearing transcript, Melbourne, 15 May 2008, p. 6.

20 ACCC public hearing transcript, Sydney, 1 April 2008, p. 144.

21 ACCC determination, application for authorisation A90745, Premium Milk Supply Pty Ltd.

Chart 12.1 Increases in CPI, milk price index, private label milk sold through supermarkets price index and farm gate price index, 2002 to 2008.



Source: CPI and milk price index data sourced from ABS (cat. no. 6401.0); private label milk sold through supermarkets price data sourced from Dairy Australia and first reported in *Dairy Australia Industry in Focus 2007*, p. 26, ACNeilsen and Dairy Australia; farm gate price data sourced from Dairy Australia

12.1.2 Dairy processing

Key inputs/costs and their movements over time

Raw milk is the key input into the production of drinking milk. Information provided by processors in response to s. 95ZK notices indicated that the cost of raw milk ranged from around one-third to over half of the total cost to the processor of producing white drinking milk. As noted previously, the cost of raw milk to processors has increased by upwards of 40 per cent in the last 12 months and in some states is expected to continue to increase for the immediate future.

Other key costs in producing drinking milk identified by processors were packaging, labour and distribution, including freight and transportation. Processors reported significant increases for each of these costs over the last 12 months, in many cases by more than 10 per cent. Increases in distribution and transport costs were primarily driven by rising fuel prices while packaging costs were affected by rises in the price of high-density polyethelene resin.

All processors stated that they had not been able to fully pass on these cost increases through increasing wholesale prices for either branded or private label products. Processors stated that they had particular difficulty in recovering increases in costs of supplying private label products to supermarket chains because of existing contractual arrangements. These arrangements are discussed further in this report.

Supply arrangements with supermarket chains

Supply arrangements between dairy processors and retailers differ depending on whether the processor is supplying their own, branded milk or retailer branded private label milk.

Branded product is generally supplied on trading terms, setting out the products to be made available, which are fixed for one to three years and subject to automatic renewal unless renegotiated. Trading terms do not ordinarily specify wholesale prices. Rather, wholesale, or list, prices are set by the processor.

While processors set list prices, most customers do not pay the list price. Rather, trading terms, as negotiated on a customer-by-customer basis, set out a range of discounts, rebates (including warehouse allowances, discount allowances, access to promotional activity, settlement discounts, ullage and business volume rebates) and fees applicable to supply.

Processors are not generally contractually restricted in their ability to raise wholesale list prices for branded milk. However, increases in wholesale prices are generally passed on by retailers and reflected in retail prices.

Generally speaking, larger customers will be supplied on more favourable terms (i.e. more generous rebates and discounts). For example, in its public submission Fonterra stated that it achieves lower unit costs, predominantly linked to volume, when selling to large customers. Fonterra states that additional benefits in dealing with larger customers include consistent purchasing patterns which enable manufacturing efficiencies. Fonterra stated that if a smaller wholesaler or retailer was to purchase the same volume as a larger customer, in general, they may be able to achieve similar discounts from Fonterra to the larger customer.[22]

Private label product is supplied under fixed contracts, generally of between 12 months' and three years' duration, set through competitive tender processes.

Contracts set out fixed wholesale prices and other terms and conditions. Contracts provide details of the specifications of the product, including packaging and branding, delivery and usually include an estimated volume, although actual volumes are determined through the life of contract terms based on actual retail sales.

Contracts usually allow for limited review of wholesale pricing at specified intervals. However, more generally, the capacity to vary wholesale prices during the life of the contract—for example, where input costs such as farm gate prices rise—is more limited.

The ACCC understands that Woolworths tenders for supply of private label milk on a national basis whereas Coles and Metcash currently tender on a state-by-state basis.

These competitive tender processes have resulted in processors supplying private label milk to the MSCs at much lower prices than the equivalent branded product. Broadly speaking, wholesale prices for private label product are significantly lower than for branded product. While differences in branded and private label wholesale prices varied significantly, many were in the 20 per cent to 40 per cent range.

In confidential evidence provided to the ACCC processors indicated that their key considerations in deciding whether to tender to provide private label milk to retailers included: available production capacity; ability to meet customer specifications and source necessary raw materials (i.e. raw milk) and financial return.

22 ibid.

As noted, all processors who provided evidence to the ACCC noted significant increases in costs of production over the past 12 months. Processors contended that they have not been able to fully pass through these costs, particularly with private label products. Processors contended that this was because of the highly competitive prices that apply to private label milk as well as the bargaining strength of the MSCs.

Processors noted that the ability to pass through increases in wholesale prices on private label milk is governed by contracts with retailers and retailers' reluctance to accept cost increases while those contracts are in place.[23] However, it was also noted that the MSCs will, on occasion, accept some increases in the wholesale price of private label product notwithstanding that they are not contractually obliged to do so, where it can be demonstrated that input costs for the processor have increased significantly.

The contention that processors have not been able to fully pass through these costs, particularly with private label products—or at least that they have not passed them through—was supported by information provided to the ACCC by processors and the MSCs in response to s. 95ZK notices, which showed that recent increases in cost of production have been more fully reflected in increased wholesale prices for branded milk than private label.

One issue on which the ACCC heard mixed evidence through the inquiry was the extent to which processors have increased the price of branded products to offset cost increases in producing private label products.

In evidence given confidentially at hearings, and in response to s. 95ZK notices, processors indicated that they did not generally engage in this practice. However, one processor did indicate that increased costs for branded products have been able to be recovered in a 'more timely manner' and another indicated that prices of branded products have sometimes been increased to off-set overall cost increases, both for branded and housebrand products.

Decision to supply private label product

Given the comparatively lower wholesale price received by processors when supplying private label milk, for what is essentially the same product, and the limited ability for processors to pass on increases in production costs, this raises the issue of why processors tender to supply private label milk products.

In confidential evidence provided to the ACCC, processors indicated that the main reasons they pursued private label contracts were:

- overhead recovery—generating revenue through private label sales to contribute to fixed costs of running the business
- supply relationships with retailers—supplying private label product provides a stronger relationship and possibly improves processors bargaining position in relation to branded products
- volume—the volume of milk supplied through private label contracts provides some stability to the business.

In addition, in evidence given at a public hearing, Parmalat noted that at the time of farm gate deregulation (in 2000) there was significant excess capacity in the industry, and, consequently, processors were looking for opportunities to utilise that capacity. Parmalat contended that this provided a strong competitive tension to the point where the processors were prepared to tender for private label business at very low prices in order to utilise capacity. Parmalat considered that wholesale prices were

23 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 49.

driven down by this excess capacity, creating a gap between wholesale prices for branded and private label product which then expanded over time.[24]

Recent movements in wholesale prices

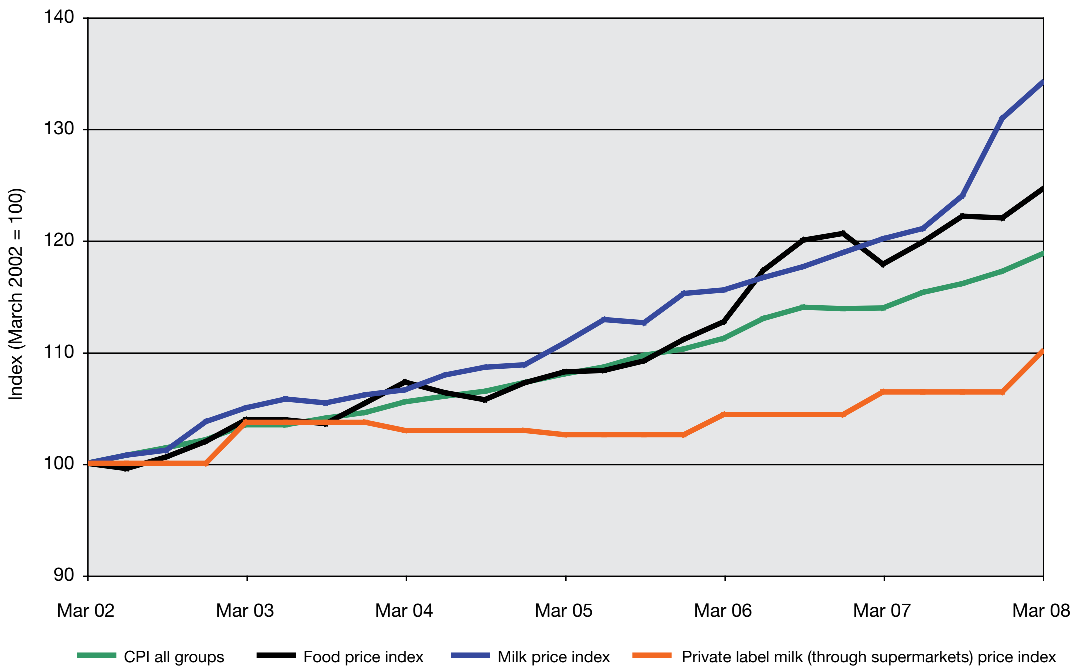
Information provided to the ACCC in response to s. 95ZK notices illustrates the wholesale prices on both branded and private label product supplied to the MSCs increased by about the same amount in 2006–07. However, there was a significant divergence in the rate of increase of wholesale prices between branded and private label product in 2007–08. Reflecting the bargaining position of the MSCs and the processors contractual supply obligations—as processor input costs, particularly farm gate milk prices, increased—the rate of increase in wholesale prices for private label products was significantly lower than for branded products.

12.1.3 Retail prices and margins

Retail prices

White drinking milk sold by the MSCs is priced in three tiers: private label (Woolworths Homebrand and Coles Smart Buy), which from October 2007 to March 2008 retailed at around $2.20 for a two litre carton; 'premium' private label (You'll love Coles and Woolworths milk) sold at around $2.60 for two litres; and branded product, such as Pura, Dairy Farmers and Pauls, which generally retailed for around $3.40 to $3.60 for two litres.[25]

Chart 12.2 Increases in CPI, the food price index, milk price index, and private label milk sold through supermarkets price index, 2002 to 2008.



Source: CPI, food price index and milk price index data sourced from ABS (cat. no. 6401.0); private label milk sold through supermarkets price data sourced from Dairy Australia and first reported in *Dairy Australia Industry in Focus 2007*, p. 26, ACNeilsen and Dairy Australia

24 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 49.

25 Price will vary by state. In particular Woolworths Homebrand and Coles Smart Buy are not available in all states.

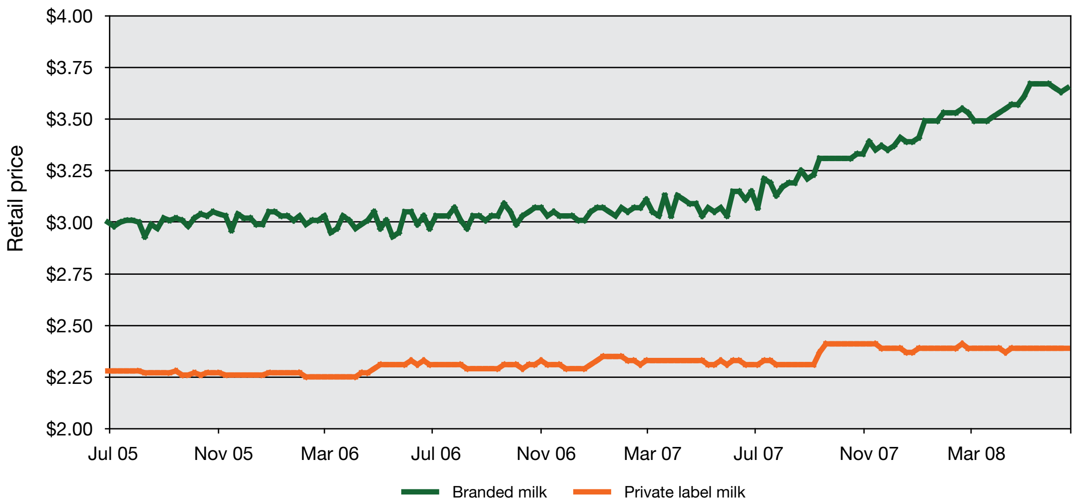
ABS statistics indicate an average annual increase in the retail price of milk of 4.1 per cent for 2002–03 to 2006–07. Questioned about these figures at hearings, dairy processors were of the view that the figures accurately reflected movements in the price of branded milk products, but that increases in retail prices for private label products, which make up around 55 per cent of all drinking milk sales through supermarkets, were significantly less than this.

The ACCC was also provided with retail sales data by the MSCs, dairy processors and Dairy Australia. Price movements varied by product and state, but those reported roughly accorded with the evidence given by processors at the hearing. Price movements for branded white milk sold through the MSCs roughly accorded with movements in the milk price index reported by the ABS, whereas movements in retail prices for private label milk products sold through the MSCs were significantly less than this.

Retail milk prices as measured by the ABS milk price index increased by about 10 per cent in the nine months to March 2008, reflecting increases in farm gate raw milk prices are flowing through into wholesale and retail prices. However, as noted, the extent of the pass through is less on private label than on branded products.

Processors reported increasing gaps between the retail price of private label and branded milk, largely reflecting differences in the extent to which increases in production costs are being reflected in wholesale prices, as discussed in section 12.1.2. It is these price differences that have largely driven the growth in sales of private label products over recent years.

Chart 12.3 Unit prices 2 litre milk May 2005 to April 2008



Source: Dairy Australia, *Dairy 2008: situation and outlook*, 2008, p. 36

Processors observed that it may be the case that over time this gap in the wholesale, and retail, price of private label and branded milk is not sustainable given the share of sales MSCs private label products enjoy, and given these volumes, the necessity in the long run for any increases in production costs to be reflected in wholesale prices so as to maintain supply.[26]

26 ACCC public hearing transcript, Brisbane, 3 April 2008, p. 49.

Retail margins

While retailer gross margins varied between product, retailer and across states, certain trends in the MSCs gross margins were apparent.

Broadly speaking, gross margins on higher price private label products (Woolworths milk and You'll love Coles) were generally in the range of 25 per cent to 30 per cent. Gross margins on branded product were generally in the range of 20 per cent to 25 per cent and gross margins on lower priced private label products (Coles Smart Buy and Woolworths Homebrand milk) general ranged from 15 per cent to 20 per cent.

The difference in the gross margins on higher price private label products and lower priced private label products is almost solely a reflection of the difference in the retail price of these products.

While gross margins have moved over time, by product and across states, information provided by the MSCs and dairy processors indicated little change in aggregate gross margins over the last five years. Specifically, a number of processors provided the ACCC with information in response to s. 95ZK notices, which tracked movements in retail and wholesale prices. This data indicated that movements in retail prices charged by the MSCs for white drinking milk supplied by the dairy processors that provided information to the ACCC generally tracked movements in wholesale prices at which these products were supplied to the MSCs.

This indicates that there has been little change in the competitive environment at the retail level in recent years. This also suggests that the bargaining power of the MSCs in negotiating terms of supply for private label products is being reflected in retail prices. Specifically, it appears that the limited ability for processors to reflect increases in production costs in wholesale prices for private label products means that these increases in product costs are also not reflected in retail prices for private label products. In other words, consumers are benefiting from the buyer power the MSCs have in sourcing private label milk.

12.1.4 Conclusions

The cost of raw milk, which makes up about 25 per cent to 44 per cent of the retail price of white full-cream drinking milk, has increased significantly in the last 12 months driven primarily by rising world demand for dairy products and reduced domestic supply.

However, while farmers are enjoying near record farm gate prices, costs of product have also increased significantly, which is reflected in the fact that, notwithstanding historically high farm gate prices, domestic raw milk production has fallen in recent years.

Given that raw milk is such a key input into producing drinking milk, processor costs of production have also increased significantly. These increased costs of production are being reflected in wholesale prices for branded milk. However, processors contractual obligations, and the bargaining power of the MSCs, mean these increased costs of production are not being reflected to the same extent in wholesale, or retail, prices for private label milk.

While retail milk prices have increased at a rate above CPI and the general food category, these figures likely overstate the extent of increases in the price of private label milk sold by the MSCs.

The rate of increases in milk prices has accelerated significantly over the last 12 months, primarily reflecting increasing farm gate prices. However, the MSCs bargaining power for the supply of private label products means that increases in production costs are not being fully reflected in wholesale or retail prices for private label milk.

12.2 Chicken

Key points

- Retail poultry prices have remained relatively stagnant over recent years but have increased significantly since the start of 2007.
- Increases in retail prices have been largely as a result of increasing production costs.
- Strong competition between chicken meat processors has meant that not all of the production cost increases being experienced are being reflected in wholesale prices.
- Competition at the retail level means that retailers have also absorbed some of the increase in production costs.

Consumption of chicken meat has grown steadily in recent years to the point where chicken has overtaken beef as Australia's most preferred meat.[27] This growth in consumption is primarily a consequence of the retail price of chicken, relative to other types of meat, steadily falling and consumers' perceptions of chicken as a leaner and healthier option than red meat. Trends towards convenience food and eating outside of the home have also favoured chicken consumption.[28]

The supply chain for chicken has three main participants:

- the chicken grower
- the vertically integrated processor
- retailers, such as MSCs and other large purchasers of chicken (including takeaway food outlets).

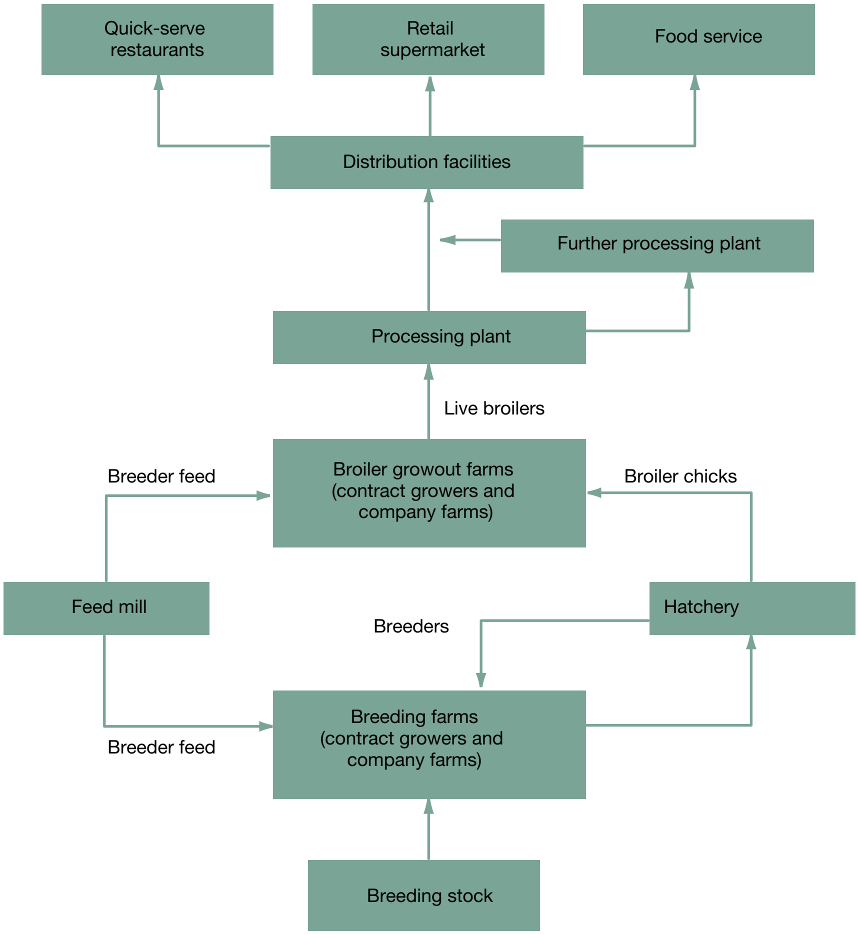
Chicken carcases can be processed into a variety of cuts and other value added products. However, the chicken breast accounts for about 60 per cent of total revenue for the bird.

This case study examines costs, prices and margins in the supply chain for chicken, focusing on the chicken breast product.

27 Department of Agriculture, Fisheries and Forestry (DAFF), *Foodmap: a comparative analysis of Australian food distribution channels*, 2007, p. 38.

28 IBISWorld, *Poultry Processing in Australia*, 4 June 2008, p. 28.

Chart 12.4 Diagrammatical representation of the chicken meat supply chain



Source: NSW Farmers Association, submission no. 155, p. 26

12.2.1 Chicken growers

The chicken meat industry operates largely through vertical integration with company ownership of breeding farms, multiplication farms, hatcheries, feed mills, some broiler[29] growing farms and processing plants. However, growing of chicks is more commonly outsourced. Integrated processors supply day-old chicks and feed to contract growers or company-owned farms, collect the grown chicks and then distribute and market the meat. Growers provide specialised shedding and variable inputs such as labour, gas, electricity and management expertise in overseeing the growing of the chicks, which remain the property of the processor. The location of chicken farms is influenced by the location of feed mills, water and power supplies, processors and heavy transport.

29 'Broiler' is the industry term for a chicken reared for meat production.

The contract growing of chickens is capital intensive. The average contract farm consists of three to four growing sheds, each with floor area of around 1200 m^2. The replacement cost of such sheds, with their internal equipment, is approximately $200 to $300 per square metre. Chicken-growing sheds are highly specialised and have virtually no alternative use; they are also non-portable.

The processor–grower relationship

Each mainland state has in the past regulated the commercial relationship between chicken meat growers and processors; some of these states are still doing so. These regulations have generally established an industry committee of grower and processor representatives to negotiate standard contract terms for the supply of growing services to chicken meat processors.

As a result of legislative reviews carried out under National Competition Policy (NCP) requirements, a number of states have moved away from regulated commercial relationships between processors and growers to partial or fully deregulated industry arrangements. Following these legislative changes the ACCC granted authorisation to a number of applications lodged by chicken meat growers to collectively negotiate growing contracts with processors.[30]

Submissions argued that following deregulation, competitive pressures on individual growers are increasing as processors demand lower prices. The Victorian Farmers Federation argued that since the deregulation of chicken growing in Victoria, the negotiation of fees and terms between growers and processors has become more difficult.[31] The VFF also claimed that processors do not compete with each other for growing services, which diminishes the bargaining power of growers in negotiations.

As noted, the ACCC has considered a number of applications for authorisation for chicken growers to collectively bargain with processors in recent years. In considering these applications, the ACCC has acknowledged the comparatively weak bargaining position of growers in their negotiations with processors. There is little capacity for growers to provide a different service, primarily because of the specificity of their assets. In addition, there are significant switching costs in moving between processors, costs that are typically borne by the grower. In addition, processors are generally large, well resourced businesses with significant commercial and negotiating expertise. Growers, in contrast, are generally small primary producers with often limited resources and expertise to engage in effective negotiations with businesses with the size and negotiating expertise of processors.

The ACCC has previously concluded that if growers were to negotiate individually with processors, the likely consequence of this imbalance in bargaining power would be the offering of standard form contracts by processors with little input from growers and little scope for them to vary contract terms.[32]

While addressing this imbalance in bargaining power is not in itself the primary reason the ACCC has authorised arrangements allowing growers to collectively bargain with processors, growers are likely to have a degree of countervailing bargaining power in negotiations with processors if they are able to negotiate collectively.

However, the ACCC is also aware that not all processors have chosen to participate in these collective bargaining arrangements and many growers still operate on individually negotiated, or standard form, contracts.

30 Details of these applications for authorisation are provided in appendix H.

31 VFF Chicken Meat Group submission no. 70, March 2008, p. 4.

32 ACCC determination, *Applications for authorisation lodged by the Victorian Farmers Federation on behalf of its member chicken meat growers in relation to collective bargaining by chicken meat grower groups with their nominated processors in Victoria*, 2 March 2005, p. 30.

Growing fees

Growing fees often depend on the type of facility used and can be incentive-based. Confidential evidence from various sources indicates that growing fees currently range from 56 to 64 cents per bird. The NSW Farmers Association contended that the fee chicken growers receive equates to 7.9 per cent of the bird's retail price on a dressed frozen chicken (or 30 cents per kg).[33]

While the fee received by the grower may appear to be a small component of the retail price, it is important to note that, unlike livestock farmers, growers are essentially contractors and many of the inputs into the growing process are supplied by the processor.

An industry participant confidentially submitted that fees paid to growers have not kept pace with the increase in growers' costs. Such an outcome is consistent with the assertion that growers are often in a weak bargaining position in their negotiations with processors.

12.2.2 Chicken meat processing

The major chicken meat processors in Australia are Inghams Enterprises, Bartter Enterprises and Baiada Poultry. Combined, these three privately owned companies supply about 80 per cent of Australia's broiler chickens.[34] The balance of chickens produced in Australia is supplied by seven processors, each supplying 1 to 3 per cent of the domestically produced chickens and a number of smaller processors. Most of the chickens grown in Australia come from two breeds, the Cobb and the Ross. Bartter has the contractual right to import the Ross, while Inghams and a consortium, which includes Baiada, has rights for the Cobb.[35] Consequently, small processors depend on the larger processors for day-old chicks.

Most chicken meat produced in Australia is consumed domestically, with less than 3 per cent exported. Although quarantine laws permit the importing of cooked chicken meat from New Zealand and several other countries, subject to certain regulations[36], imports represent a negligible amount of total poultry consumed in Australia. Therefore, unlike other meats such as beef, world prices have little influence on the wholesale price of chicken meat in Australia.

Trends in key input costs

The major cost contributors to chicken meat processing are:

- the cost of the chick
- growing fees
- feed
- medication
- transportation and processing
- packaging and distribution.

Grain costs have increased substantially in recent years. Chickenfeed comprises 85 to 90 per cent of

33 For dressed frozen chicken.

34 Australian Chicken Meat Federation Inc, accessed at www.chicken.org.au/page.php?id=2, 5 March 2008

35 ACCC determination, *Applications for authorisation lodged by the Victorian Farmers Federation on behalf of its member chicken meat growers in relation to collective bargaining by chicken meat grower groups with their nominated processors in Victoria*, 2 March 2005, p. 14.

36 DAFF, *Chicken meat overview*, accessed at www.daff.gov.au/agriculture-food/meat-wool-dairy/ilg/industries/chicken_meat, 2 June 2008.

grains such as wheat, sorghum and barley.[37] Inghams indicated that feed prices have been increasing since 2002 and that between 2005 and 2007 their feed costs effectively doubled.[38]

While the extent of the impact of the rising price of grain on the final retail price of chicken varies, confidential evidence suggested that every $10 per tonne increase in feed costs adds around 3.5c to 4c to the cost of each kilogram of dressed bird. The feed cost increase between 2005 and 2007 alone could be estimated to have added from between 88c to $1 per kg to the final cost of producing a dressed bird.

Confidential evidence from another industry participant indicated that as well as feed cost increases, material cost increases have been experienced in other inputs. In particular, they indicated that from 2002 to 2008 the cost of chicks increased by 26 per cent and the fee paid to the grower increased by approximately 37 per cent per bird.

While the contribution of each of these inputs to the cost of producing a chicken will vary, information provided confidentially suggests that the cost of feed represents more than half of the cost of producing the live bird. However, the substantial costs involved in further processing to produce the chicken breast product are such that the live bird cost represents just under one-third of the wholesale chicken breast price.

Limited data has been received regarding the costs of processing a whole live bird into the chicken products sold at supermarkets. These costs include transportation, processing, packaging and other related costs. An industry participant confidentially indicated that labour and energy costs have increased steadily over recent years and would further add to the total cost of production. However, it was also submitted that continued productivity improvements have occurred in the processing stage of production. Plants have been rationalised and have become increasingly automated. It appears that rising costs in this stage of production have been off-set to some extent by continued productivity improvements.

12.2.3 Supply arrangements with supermarket chains and other major customers

Processors predominantly sell chicken meat in the state in which it is produced, although improvements in distribution and transport logistics mean that product may now be shipped safely and economically anywhere in eastern Australia within 24 hours.[39]

Supermarket chains (particularly MSCs), the food service industry and quick-service restaurants, which include large fast food chains such as McDonald's and KFC, are the major wholesale purchasers of chicken meat. IBISWorld estimates that around 30 per cent of final sales of chicken meat are made through supermarkets and major retailers.[40] Small retailers, specialty chicken shops and butchers, are estimated to have a combined share of sales of around 20 to 30 per cent. The combined share of sales of fast food and takeaway outlets is also estimated to be between 20 and 30 per cent. Remaining sales are through other outlets such as restaurants and hotels. However, the sales profile for an individual processor could be considerably different, as submissions have tended to point towards processors sometimes forming long-term relationships with particular purchasers.

37 Australian Chicken Meat Federation, accessed at www.chicken.org.au/page.php?id=6, 4 July 2008.

38 ACCC, excerpts (public) from confidential transcript of Ingham Enterprises Pty Ltd, Sydney, 1 April 2008.

39 ACCC draft determination, *Application for authorisation lodged by Bartter Enterprises Pty Ltd, La Ionica Operations Pty Ltd, Hazeldene Chicken Farm Pty Ltd, Inghams Enterprises Pty Ltd, Baiada Poultry Pty Ltd and consenting Victorian chicken growers in relation to the collective negotiation of chicken growers' contracts in Victoria,* 17 November 2004, p. 4.

40 IBISWorld, *Poultry Processing in Australia*, 4 June 2008, p. 7.

Typically MSCs source supply through an annual tender process. Submissions indicated that these tender processes are very competitive. For example, confidential evidence contended that on occasions MSCs will make a processor aware of a lower price tendered by a competitor and provide the opportunity for tenders to be revised accordingly.

Other evidence available to the ACCC supports the view that the processor–purchaser relationship is dynamic. Processors frequently lose and win individual tenders to and from large and small competitors. MSCs and other buyers appear to routinely review supply arrangements to ensure competitive pricing and have a relatively large number of processors vying for their business. Likewise, confidential evidence indicated that processors have the opportunity to negotiate with MSCs to pass on their cost increases during the supply agreement.

Evidence to the inquiry also noted that as the product purchased by MSCs (and other purchasers) is homogenous, purchasers can switch to another processor if they see cost advantages in doing so. Similarly, processors have the option of supplying other purchasers if they can achieve a better price. Notwithstanding this, evidence to the inquiry suggests that the long lead times and the sheer volumes required by the MSCs preclude them from capriciously cancelling orders or switching to another processor as both MSCs and processors would need adequate notice of the beginning or ending of a supply agreement.

Although processors may have a number of outside options, Coles and Woolworths, as the two largest single buyers, are in a position to exercise some buyer power in their negotiations with processors. That is, a processor losing business with either supermarket could result in under-utilised capital until other purchasers of similar volumes are found or the processor regains similar volumes of MSC business through future tenders. Therefore, a processor with a large proportion of its business with either supermarket has a strong incentive to retain it even if the terms are less than favourable. Similarly, processors are likely to compete strongly for business with MSCs because they have the attraction of a high volume customer base.

Evidence obtained during the inquiry suggests that the strong competitive tension between processors has meant they have not been able to fully pass on recent increases in production costs. Competition to supply the MSCs appears particularly strong, with the MSCs sometimes playing processors off against each other to ensure supply on the most favourable terms possible.

In addition to tender processes, the MSCs and processors often engage in further negotiations on discounts and volumes for the purpose of running promotions. These negotiations are often beneficial to, and sought by, both parties. For example, processors and an MSC often devise promotions to even out demand across different poultry products, enabling processors to sell cuts of the carcase accumulating through another part of the business while increasing custom for the MSC.

As noted, there appears to be quite vigorous competition between processors. Processors compete against each other mainly on price and are under constant pressure to reduce costs and increase productivity to ensure they can offer the lowest price to retain or gain business. At the same time, processors are confident that the volumes they are supplying cannot be supplied by their competitors at short notice and that they do have outside options in terms of buyers. This environment appears to have been conducive in recent years to strong productivity growth and cost increases being minimised or absorbed.

Wholesale prices

The breast cut of chicken is the highest value cut of the chicken, accounting for about 60 per cent of total revenue from the bird. Based on data provided confidentially, the ACCC has estimated that the average net price of skin off breast fillet (per kilogram) sold to major MSCs, wholesalers, independents and specialty stores by major processors increased by around 10 per cent between 2001–02 and 2004–05. Prices fell by around 4 percentage points in 2005–06, primarily as a consequence of reduced demand relating to concerns regarding avian influenza outbreaks overseas, before they returned to their 2004–05 levels in 2006–07.

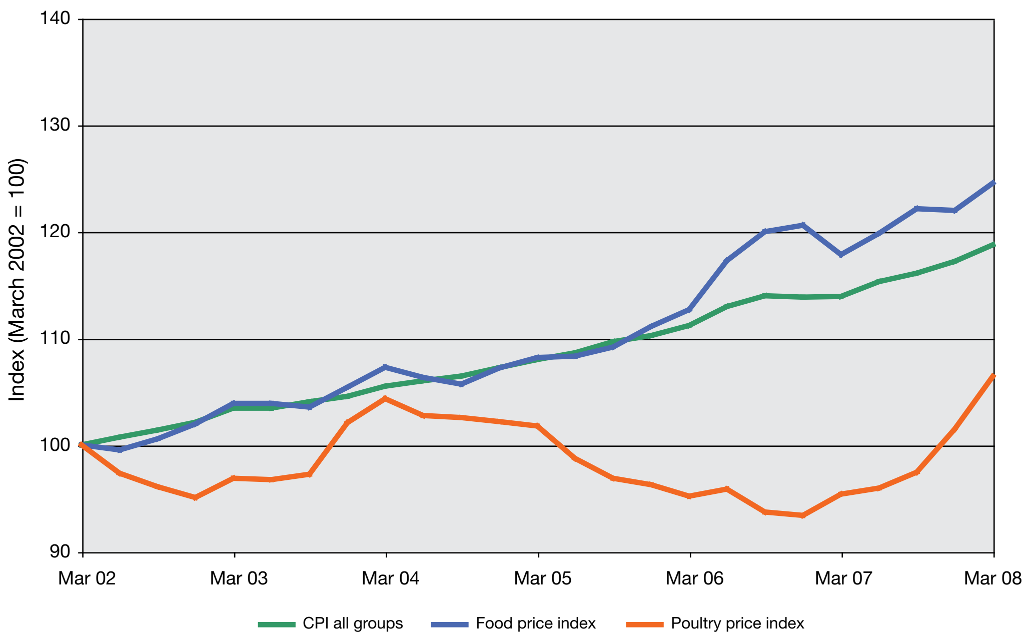
As noted, while processors have submitted that these increases in wholesale prices have been insufficient to offset increases in production costs, some of the increases in production costs have been offset by improvements in the productivity of processor operations.

Retail supply of chicken meat

In real terms the retail price of chicken has fallen substantially since the 1950s. For example, between 1980 and 1989 alone the retail price of poultry (at constant 2006–07 dollars) fell from $7.08 per kg to $5.03c per kg.[41] This decrease in real prices was primarily a consequence of improvements in on-farm and off-farm productivity through a combination of better management, genetic improvement, economies of scale and mechanisation of processing facilities.[42]

The ABS poultry price index indicates that while poultry prices have fluctuated over the last five years, they have not changed significantly, with prices in March 2008 around 6 per cent higher than six years earlier. This is significantly below the rate of increase in CPI and the food price index recorded by the ABS.

Chart 12.5 ABS CPI comparisons—all product groups, food products and poultry



Source: ABS, consumer price index, Australia, catalogue no. 6401.0, March 2008

41 IBISWorld, *Poultry Processing in Australia*, 4 June 2008, p. 30.

42 ABARE, *Poultry industry overview*, accessed at www.abareconomics.com/interactive/ausNZ_ag/htm/au_poultry.htm, 5 June 2008.

One confidential submission suggested that MSCs quickly pass on wholesale price increases to consumers, while price falls are often retained by the retailer. However, the ability of the retailer to do this would depend upon the level of competition in the retail market. The fact that the real price of chicken has declined over the past few years—and evidence provided to the ACCC suggests that the MSCs' gross margins on the sale of chicken breast have also fallen in the last two years, as discussed below—would suggest that to the extent this does occur, it is at best a short-run phenomenon.

Confidential data obtained has enabled the ACCC to calculate the average gross margin of the two MSCs from April 2006 to December 2007 on chicken breast. Over this period, the rate of increase in retail prices did not keep pace with the rate of increase in wholesale prices, resulting in declining gross margins for the MSCs. This suggests that while some of the noted increase in production costs is being absorbed by processors, of the proportion of the increase that is being passed through in wholesale prices, some is being absorbed by the MSCs, indicating competitive tension at the retail level.

12.2.4 Conclusion

Decreasing poultry prices, relative to red meats, and consumer perceptions of chicken as a leaner and healthier option than red meat have seen consumption of chicken meat growing steadily in recent years to the point where chicken has overtaken beef as Australia's most preferred meat.

While the rate of increase in poultry prices has been significantly less than CPI or general food price inflation over the last five years, retail poultry prices have risen significantly in the past 12 to 18 months.

Increasing poultry prices have been primarily driven by increasing production costs. However, strong competition among poultry meat processors has constrained their ability to raise wholesale prices. Similarly, competition at the retail level has meant that the proportion of the increase in production costs reflected in wholesale prices is not fully reflected in retail prices.

12.3 Apples

Key points

- The ACCC has found that the price of apples sold in supermarkets generally follows the wholesale market prices.
- While the margin made on apples fluctuates, the ACCC has not found any evidence that retailers are charging more for apples while at the same time pushing the wholesale price of apples down.
- There appears to be strong competition throughout the supply chain for the production and supply of apples.
- Between 50 and 65 per cent of fresh apples sold in Australia are sold through either Coles or Woolworths, approximately 5 per cent through other grocery retailers, 25 per cent to 40 per cent through greengrocers and 5 per cent are exported.
- At the retail level the local competitive dynamic plays a strong role in setting prices. A competitively priced greengrocer in the immediate vicinity of a MSC will be reflected in the MSC charging lower prices for apples.

Apples are grown in all six Australian states (although not in the Northern Territory). Victoria is Australia's largest producer of apples, producing more than 30 per cent of the nation's apples—mostly from the Goulburn Valley area, around Shepparton. New South Wales is the next largest apple-producing state.[43]

The main apple varieties grown traditionally have been Red Delicious and Granny Smith (55 per cent of production in 1998–99). However, newer varieties such as Gala, Fuji, Cripps Pink (which may be sold using the trademark brand name Pink Lady) and Cripps Red (which may be sold using the trademark brand name Sundowner) now account for more than 40 per cent of production.[44]

12.3.1 The supply chain

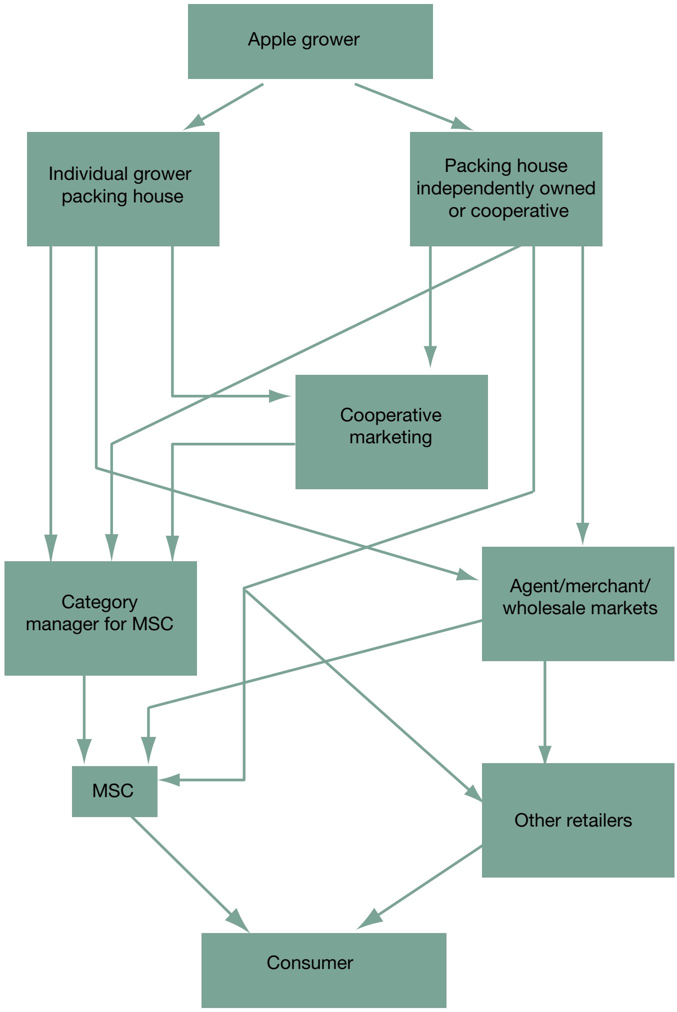
Chart 12.6 is a diagrammatic representation of the apple supply chain. Once grown, apples are picked into large bins. They are then packed into cartons, either on-site in the case of large integrated grower/packers or by a third party in circumstances where the grower does not operate their own packing facility.

Packed apples are then supplied directly to some larger retailers through their distribution centres or to wholesale markets. Smaller retailers will generally source their apples from the wholesale markets rather than directly from growers/packers.

43 Apple and Pear Australia Limited (APAL), 'Statistics', viewed on 28 April 2008, www.apal.org.au.

44 APAL, 'About APAL', viewed on 28 April 2008, www.apal.org.au.

Chart 12.6 Diagrammatic representation of the apply supply chain



Source: APAL

As apples vary in variety, appearance, size, taste and general marketability, they can be sold in various forms, from premium apples to second grade or prepack apples. Premium apples generally meet the size, colour and taste specifications of the MSCs, and are therefore able to be sold at a premium price in retail stores.

If the apples are of a poor quality and are unable to be sold either through retailers or the wholesale markets as fresh produce, they are generally used in juicing or canning (although canning does not represent a significant portion of the apple processing performed in Australia).

There has been significant development in the preservation of apple quality in the last 10 years. R Ceravolo & Co. noted in a public hearing that apples are now:

> … picked into bulk bins. From bulk bins they're transported into the cold storage facility where they're either dipped or drenched … to stop any mould spreading in the bins if there is any or anything breaking down. From there they get put into … Controlled Atmosphere, which [reduces] the oxygen in the room and the carbon dioxide, slowing down the ripening process.[45]

Controlled atmosphere processes allows growers to slowly release produce over the length of a year, thus allowing retail outlets to source apples all year round.

12.3.2 Apple growing

Key inputs and changes in their costs

The major inputs in apple growing are:

- labour
- water
- fuel, fertiliser and transport
- packaging requirements
- grading requirements.

Of these, the single greatest input is labour. The chairman of Apple and Pear Australia Limited (APAL) has stated that labour costs represent on average more than 70 per cent of the cost of apples at the farm gate.[46] Labour shortages in recent years have particularly affected the industry as production is predominantly regionally based and to some extent reliant, particularly with picking, on casual labour.

In recent years the drought has severely affected apple crops. As a result of the declining availability of water, many apple growers have been forced either to buy water allocations or to reduce the size of their crop, which in turn has affected apple supply.

The increasing price of fuel has also severely affected input costs. As orchards are generally located in regional areas, transportation costs have, by some estimates, doubled in 2008 because of high fuel prices.[47] Fertiliser, an important input into apple growing, has also increased dramatically in price in the last 12 months, adding significant costs to apple production.

Another factor growers identified as increasing their production costs is the recent introduction by both Coles and Woolworths of their own individual packaging, either black plastic crates or black boxes. Growers are required to rent the crates from either Coles or Brambles (CHEP)—which manages the supply and distribution of the crates for Woolworths. For many growers, this has added a significant cost as they are required to pack stock for each MSC in a different type of packaging, while all other stock must be packed in their own packaging. This has resulted in increased costs in the initial stage of packing and can significantly adds to costs if produce is rejected by either MSC and needs to be repackaged. In the case of Woolworths, the ACCC received confidential information from growers concerning shortages of the required plastic crates, resulting in growers/packers stockpiling crates, thus adding to crate costs.

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45 ACCC, public hearing transcript, Adelaide, 28 April 2008, p.47.

46 Darral Ashton, *Planning for the future—presentation to Outlook 2007*, viewed on 5 May 2008, www.abareconomics.com/interactive/Outlook07/files/dayONE/Ashton_Hort.pdf.

47 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 69.

The use of these crates has enabled both Coles and Woolworths to use 'one-touch packaging'—where rather than unpacking the grower's own boxes to fill the supermarket shelves, the supermarket packer is now able to simply accept the crate from the grower and place it straight onto the shelf, thus reducing the MSCs' labour costs. As such, the introduction of these crates has reduced Coles and Woolworths packing and handling costs. However, it also appears to have increased the costs of growers in supplying Coles and Woolworths. The ACCC understands that the increased cost to growers has not been reflected in the prices paid by either MSC for the produce.

12.3.3 Packing

Packing of apples is one of the key input costs for growers, after the costs of actual production. The packing shed/grading facilities play an integral role in the apple supply chain.

The latest grading machines use a conveyor system which utilises an individual cup system that weighs each piece of fruit and passes the fruit through a colour vision grader where the colour and blemish levels are assessed by a computer. This system automatically allocates fruit of a certain appearance and weight onto different conveyer belts: premium, second grade and bulk prepack. Grading machines have become increasingly technologically advanced in recent years, and constitute a significant cost outlay for new entrants into the industry or growers wishing to vertically integrate (in excess of $1.3 million for a high-speed grader with two lanes).

The ACCC estimates from information received from APAL and Fruit Growers Victoria (FGV) that the cost of packing apples for a fully integrated grower/packer represents around 37 per cent of the total cost of a bin of apples, while for a grower who is not vertically integrated, the cost of getting apples packed off site by a third party is more likely to be around 42 per cent of the cost of producing a bin of apples.

Indicative costs of producing a carton of apples

Each bin picked holds enough apples to fill 33 12 kg cartons. However not all apples in the bin will be suitable for sale as fresh produce. Many apples contain blemishing, bruising and markings that make them unsuitable for fresh consumption. While these defects are usually present at the time the apple is picked, they are generally not identified until apples are sorted and packed.

Once those apples unsuitable for sale as fresh produce are excluded, an average bin will include enough apples for around 16 to 18 12-kg cartons. The remaining apples are generally used as processing apples (juice and canned). Growers receive very little return on the sale of apples that are not fit to be sold as fresh produce.

Table 12. 1 shows indicative costs to a grower of producing a carton of apples based on a bin producing 18 cartons of saleable apples. The figures were supplied by APAL and were verified by various growers. These figures are indicative only as costs will vary, sometimes significantly, depending on location of orchard, size of orchard and variety of apple grown.

As noted previously, some growers are completely vertically integrated, while others simply grow apples and then transport them to a third party for packing and sale. Table 12.1 shows indicative costs for a vertically integrated grower. For a vertically integrated grower, packaging costs are not accounted for separately. Rather, they are an integrated cost in each step in the production of apples.

Table 12.1 Indicative cost to the grower of producing a carton of apples[48]

Action	Average price
Orchard production cost (includes all growing costs, including harvest)	$200/bin
Bin hire and freight to storage/packing shed	$25/bin
Storage (cool)/dipping or smart-fresh	$60/bin
Packaging cost per carton	$2.60
Outbound freight per carton	$3.20
Gross bin cost	$389.4/bin
Total cost of production per carton[49]	$21.63/carton (12 kg)

In table 12.1 the packaging cost per carton is the actual cost of the carton or crate in which the apples will be placed, not the cost of packing the apples into the carton or crate. As stated previously, the cost of packing apples, including the sorting and dipping is between 37 and 42 per cent of the cost of producing a carton of apples.

The ACCC understands from information provided confidentially by growers—and information received from APAL and FGV—that apple growers aim to achieve at least a margin of 20 per cent over their gross bin cost. It was submitted that a minimum 20 per cent return is necessary to provide a reasonable return on funds employed after overheads and to take account of the high level of risk that, it was argued, apple growing involves. It was submitted that apple growing is a high-risk industry mainly because of the unpredictable nature of the Australian climate. Apples are easily damaged by changing weather conditions, particularly hail. In recent years apple crops in certain areas have been decimated as a result of severe hail storms.[50]

12.3.4 Supply options for growers

Interested parties have advised the ACCC that growers have varying degrees of choice as to where their produce is ultimately sold. The level of alternatives available to growers is largely dependent upon the size of their operation and the way in which they manage their business. Some growers only deal directly with one or both MSCs, while smaller growers, because of their smaller volumes, must deal with MSCs through a grower consolidator. Consolidators are generally growers themselves, who supplement their own produce with that of smaller growers from within their region to obtain greater volumes. Consolidators will generally be fully integrated, having on the one site controlled atmosphere facilities, grading facilities, packing and prepacking facilities. The majority of apples supplied to the MSCs are supplied by large consolidators or growers.

In some instances consolidators will take ownership of the apples and then on-sell them. In other instances consolidators will sell them on behalf of the grower and take a commission.

12.3.5 Wholesale markets

In addition to selling directly to retailers, growers are also able to sell their apples through the wholesale markets. In the case of smaller growers, supply to the wholesaler can be either direct or through a grower or consolidator.

48 The average bin of apples also contains roughly 15 cartons of apples not sold as fresh produce. Apples sold for processing provide very little return to the grower. Accordingly, in calculating costs of production per carton, bin costs have been allocated across 18 carton bins of apples.

49 This is based on a pack out of 18 cartons—from approximately a possible 33 cartons per bin.

50 ABC online, 'Hail damage hurts apple crops', viewed on 1 May 2008, www.abc.net.au.

Where growers provide their apples to a consolidator for on-selling, without the consolidator taking ownership, or where a grower sells directly to a wholesaler, growers have submitted that they are sometimes unsure of where their produce is being sold, and how much the wholesaler is receiving for their goods. This issue is examined in greater detail in chapter 18, which examines the effectiveness of the Horticulture Code and makes recommendations aimed at addressing concerns, such as those raised by apple growers and noted here.

Where apples are sold by a third party, either in the wholesale market or to an MSC, the ACCC understands that the third party may charge between a 5 and 10 per cent fee from the final selling price of the apples for providing that service.

12.3.6 MSC buying

Generally the MSCs conduct an annual forecast of the amount of produce they envisage they will need before the apple season commences. Then, on a weekly basis they will meet with their growers to discuss the price and volumes required for that week. Once packed, apples are transported to an MSC's distribution centre in pallet quantities. Title passes to the MSC upon acceptance of the goods received, on the condition that they meet the quality specifications of the MSC in question. The MSCs generally have a number of growers who supply them directly, and both orders and delivery are generally made on a daily basis to ensure that sufficient stock is maintained in store.

The ACCC understands that while the MSCs buy the bulk of their apples directly from growers or packing houses owned by large consolidators or growers, at times they do rely on buying through wholesale markets to top up their supply.

12.3.7 Relative bargaining position of growers and the MSCs

Submissions received by the ACCC on the fruit and vegetable sector have by and large contended that the sector is dominated by the MSCs, and that producers are generally price takers.[51] The Bundaberg Fruit and Vegetable Growers Association stated that growers have very little capacity to negotiate as they do not hold a position of strength in the supply relationship.[52]

As discussed in chapter 14 of this report, one of the key considerations in an assessment of relative bargaining positions is the possibility of sellers or buyers having 'outside options'. From an apple grower's perspective, while there may be a range of outside options, including export, the only practical alternatives to selling to an MSC are selling to another retailer or through the wholesale markets. The range of options available to the MSCs in sourcing supply from other growers and/or through wholesale markets is far greater and more easily exercised. As would be expected in the short term, the balance of bargaining power in negotiations between the MSCs and growers will generally rest with the MSC. This may be particularly the case in instances where the grower has structured their business around supplying to the MSCs and produce large quantities of fruit that they may have difficulty selling through alternative routes.

A number of industry participants complained during the course of this inquiry that it is not uncommon practice for the MSCs to ask suppliers to reduce a negotiated price so that an MSC can match a competing retailer's offer. Some industry participants contended that while the suggestion is made in the form of a request, it is more of a demand, where the implication of not agreeing to change the price is that the volume of orders could be reduced the following week.

51 NSW Farmers Association, submission no.155, p. 3.

52 Bundaberg Fruit and Vegetable Growers Association, submission no. 88. p. 7.

The MSCs accept such requests are made but deny there is any implied threat of retribution if the request is not acceded to. However, the Costa Group, which buys on behalf of Coles, indicated in the context of questions about sharing losses of rejected produce that:

> … we all do business with people that make our job easy. Every one of us. So the consequence would be that our preference would be to align ourselves with people that make our job easy.[53]

This suggests that the MSCs and their buyers see this behaviour as rewarding loyalty whereas the grower sees it as a threat to enforce compliance with demands. Requests are often agreed to by producers, but a lower agreed price is often accompanied by lower quality product being supplied. In the ACCC's view what occurs is consistent with the operation of a working market price reduction.

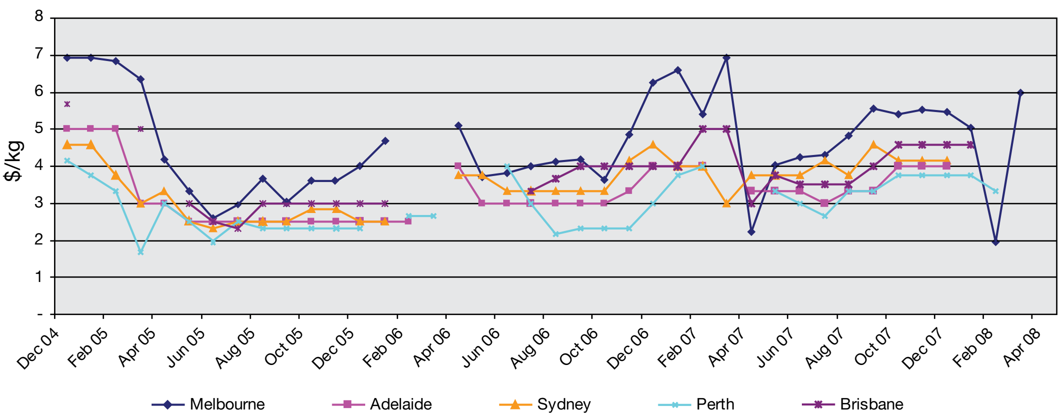
The ACCC has also confidentially received complaints from a number of suppliers of instances where the MSCs have rejected produce in store after accepting delivery at their distribution centre. Allegations were also made that rejection of produce has occurred where the produce was within specification but the price at which equivalent produce was available through wholesale markets had dropped subsequent to the growers produce being accepted at the distribution centre. The inference being that the MSC could reject the produce and obtain the same produce at a cheaper price through the wholesale markets.

The MSCs specifically denied such conduct ever occurred. In addition, growers who were summonsed to appear at hearings denied knowledge of any instance where produce is rejected for any reason other than that it was out of specification.

Given the lack of detail in the allegations made and specific denials by well-informed growers, the ACCC considers it unlikely that this kind of conduct occurs otherwise than in exceptionally rare circumstances. If specific complaints are made, the ACCC would investigate the matter under the unconscionability provisions of Part IV of the Trade Practices Act. What is clear, however, is that some growers have concerns, legitimate or otherwise, in their relationships with the MSCs. In the absence of specific complaints, the ACCC will not be able to address these issues.

Wholesale prices

Chart 12.7 Movements in wholesale prices (per kg in the Melbourne, Sydney, Perth, Brisbane and Adelaide wholesale markets for the last five years)



Source: Ausmarket

53 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 66.

As demonstrated in chart 12.6, prices have fluctuated greatly in wholesale markets, with the general trend observed being prices increasing slightly. The slight increase in average prices over the last five years is likely a reflection of tighter supply conditions as a result of the drought. The ACCC notes comments from industry participants that the drought resulted in limited supply of apples within MSC specifications, which has had the effect of:

- enabling the grower to demand more money for high-quality fruit
- specifications being altered, or
- the supply of apples at a retail level being limited.[54]

The prices received by growers through wholesale markets fluctuate on a week-to-week basis and reflect supply and demand. The price paid by the MSCs will also generally reflect the prices paid in the wholesale market. The ACCC has received evidence at public hearings that suggests that the price paid by MSCs is generally close to the top price being paid in the wholesale markets.[55] This is understandable given that the MSCs seek to stock premium quality apples.

While the price paid by the MSCs broadly reflects the price in the wholesale markets, this is not to say that the wholesale markets set the price paid by the MSCs. The MSCs purchase around 50 to 60 per cent of all apples in any given week, mostly at the premium end of the range.[56] As such, the purchasing patterns of the MSCs, which play a major role in setting demand for apples at the wholesale level, exert a strong influence over the wholesale price.

The ACCC also understands that in some weeks where the MSCs may be running specials on apples, they can pay significantly less than the market wholesale price. The ACCC understands that growers participate in these specials to generate sales volume and to maintain a healthy relationship with the MSCs. The ACCC also understands that such specials are not always initiated by the MSC; rather, in circumstances of oversupply, growers will sometimes suggest a promotion be run and offer their produce at a lower price to push through greater volume.

Data obtained by the ACCC suggests that when promotional specials are run by the MSCs in periods where there is not excess supply of apples, shortages of similar quality apples in the wholesale markets have been observed. Such a shortage may drive up wholesale prices and may result in retailers other than MSCs, which rely upon the wholesale markets for their supply, paying significantly higher prices than those paid by the MSCs.

The retail price and retail margins

APAL estimates that between 50 and 60 per cent of apples sold as fresh produce are sold through the MSCs. However, APAL considers that this figure has been slowly declining in recent years as a result of independent fruit and vegetable retail stores increasing their presence in the market.[57]

Coles noted in their public submission that the target margin for fresh produce is generally higher than dry groceries. According to Coles, this is because of:

- high spoilage rates
- higher labour costs in product preparation
- customer service and replenishment

54 ACCC, public hearing transcript, Adelaide, 28 April 2008, pp. 51–53.

55 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 51.

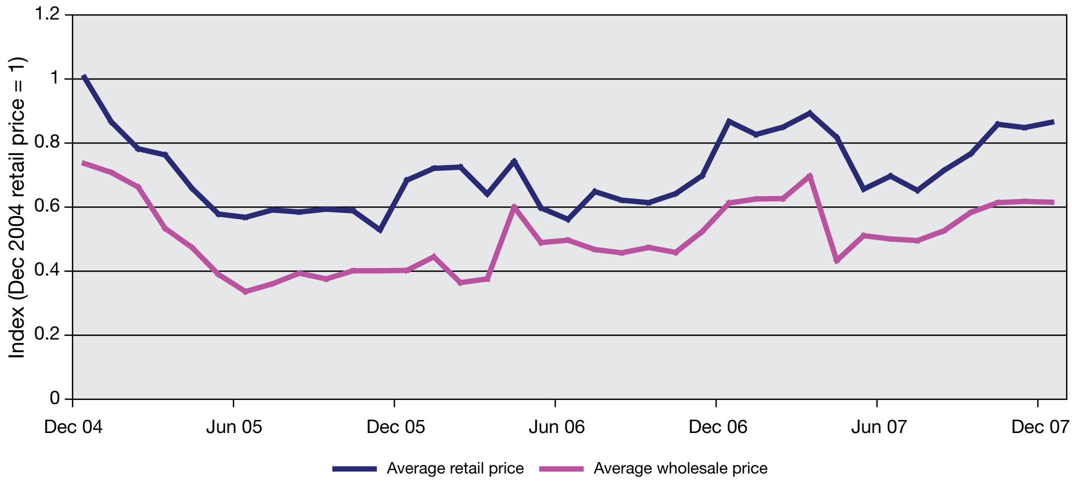
56 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 5.

57 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 5.

- costs associated with maintaining a cold chain through to display
- stringent regulations on the sale of fresh produce
- waste, or shrinkage, which can be as high as 10 per cent for some fresh produce.[58]

As illustrated in chart 12.6, price movements in the wholesale market are volatile. Confidential information provided to the ACCC by retailers suggests that fluctuations, particularly dramatic drops in wholesale prices, are not always reflected at the retail level suggesting that retailers are able to make additional profit during these times.

Chart 12.8 Pink Lady—retail average price v. wholesale average price[59]



Source: Ausmarket, Franklins, Foodland, Coles and Woolworths

Chart 12.7 is an index of retail and wholesale prices for Pink Lady apples from December 2004 to December 2007. The wholesale price data was obtained from Ausmarket, an organisation that collects pricing data at each of the wholesale markets throughout Australia, and comprises the average price across Australia's five major wholesale markets in Sydney, Melbourne, Brisbane, Perth and Adelaide.

In calculating average wholesale prices, the ACCC has used the high price given in Ausmarket market reports that give the quality specifications of the major supermarket chains. While the wholesale markets are not the primary source of apples for the major chains, the wholesale market prices reported are broadly indicative of the prices at which they are supplied.

The resulting chart (with retail prices for the first month set to 1) indicates that the retail price has moved in a pattern consistent with movements in the wholesale price. Retail margins for the most part have been reasonably constant. While at times the margin increases or decreases, the ACCC understands that this is determined by supply and demand factors. In particular, the retail price rises when supply levels fall. Movements in Pink Lady prices are broadly in line with movements that occur in the wholesale market. There is no evidence that the retailers from which the ACCC obtained data, including both Coles and Woolworths, can hold down wholesale prices while increasing retail prices. Rather, it appears to the ACCC that price movements are dictated by seasonal factors.

58 Coles, submission no. 157, freshlogic report, 28 March 2008, p. 39.

59 Data obtained from Ausmarket, Franklins, Foodland, Coles and Woolworths.

Generally, the ACCC has received confidential information from retailers that indicates that gross margin for varieties of apples are generally between 35 and 50 per cent.

While the data presented above is broadly indicative of national trends, the ACCC understands that apples are considered by supermarket retailers to be a key value item. The concept of key value items is examined in detail in chapter 4. Broadly, key value items are grocery items the larger retailers understand are compared by consumers in determining which retailer to visit. Key value items are generally products that are purchased frequently by consumers.

Large retailers will generally price their key value items at a local store level by reference to what competing retailers—be they other large retailers or, in the case of apples, greengrocers—in their immediate vicinity are charging.

For example, if a greengrocer in the immediate vicinity of an MSC is offering apples on special, it is not unusual for the MSC to similarly discount the price of apples to retain customers or attract them away from the grocer.

As a result, prices charged by large retailers can vary from store to store based on local competition. This is discussed in greater detail in chapter 5. Where competition from other large retailers or greengrocers is weaker, apples will, on average, be priced higher. Where there is strong competition, this will be reflected in retail prices. As such, the local competitive dynamic plays a strong role in setting prices of apples with a competitively priced greengrocer in the immediate vicinity of a large supermarket likely to constrain the pricing practices of the large supermarket.

In short, the price at which apples are sold by large supermarket retailers will vary from area to area dependent on the local competitive tension provided by other retailers.

12.3.8 Conclusion

Wholesale prices for apples have fluctuated significantly over the past four years, with a general trend of prices increasing slightly. Given the climatic conditions that have been prevalent over that four-year period, including substantial periods of drought and decreased water availability and allocations, it is likely that the slight increase in prices is a result of reduced supply of the types of apple suitable for sale as fresh produce.

The increase in price at the wholesale level may also in some way reflect the increased cost to growers in producing apples given the rising costs of labour, fuel and fertiliser and given that growers appear to seek a minimum margin of 20 per cent above their bin cost of production.

Retail prices for the MSCs have similarly fluctuated over time, and appear to have mirrored the trends demonstrated in wholesale pricing. The general trend for retail prices is again one of a slight increase, likely caused in some way by increasing input costs at both the wholesale and retail level.

Retail prices for apples are affected by a number of factors other than the wholesale market price. It should be remembered that the vast majority of apple products sourced by the MSCs are obtained directly from growers rather than through the central wholesale markets. Retailers price apples after examination of prices offered by their competitors in the immediate vicinity. As a result, areas where there is significant competition by the other MSC or independent retailers are likely to benefit from lower apple pricing. The retail price may also be affected by the negotiating power of specific growers, which in turn is affected by the options available to the grower to sell their product. Growers with a greater reliance upon the MSCs are likely to provide fruit at a lower price than those who are not dependent upon the same extent.

12.4 Bread

Key points

- Increases in the general price of bread have outpaced both food prices and the CPI in the last three years. However, many consumers have avoided the price increases by switching to private label bread, for which prices have remained flat.
- There appears to be strong competition throughout the bread supply chain.
- The main factor contributing to higher bread prices is higher input costs. Worldwide demand-and-supply conditions for wheat have increased the price of flour, but the rising prices of other inputs have also been important. As the cost of wheat only makes up between 5 and 10 per cent of the final retail price of bread, the affect of increases in wheat costs on bread prices appears to be overstated.
- In their dealings with the MSCs, bread producers appear to be able to pass on higher production costs more readily for branded bread, but less so for private label bread. This reflects both the buyer power of the MSCs and strong competition between manufacturers. Consumers appear to have benefited from this in the form of lower prices for private label bread.
- Retailer gross margins can vary greatly and do not exhibit a widespread trend either up or down. Competition appears to be strongest in cheap bread varieties, although the success of specialty bakeries would be imposing a constraint on supermarkets and their suppliers with regards to higher quality products.
- Of all the bread sold in Australia (excluding bread sold to the food services sector), approximately:
  - 59 per cent is sold in supermarkets
  - 31 per cent is sold in specialty bakeries
  - 10 per cent is sold in convenience stores.

There are more steps in the bread supply chain than for most other grocery items. Specific steps in the supply chain include the growing of wheat, milling the wheat into flour, baking and distribution and, finally, retailing.

This case study examines costs, prices and margins in the supply chain for bread, with a particular focus on bread produced by large wholesale suppliers and sold in supermarkets.

12.4.1 Wheat

Wheat is the most important ingredient for the production of bread. However, a number of parties (such as Agforce Grains) advised the ACCC during the inquiry that the contribution of the cost of wheat to the price of bread had been overstated by the media.[60] Coles also argued that grains make up a small portion of the total cost of bread product, and that the majority of the cost is in the form of labour, energy and packaging.[61]

60 Agforce Grains, submission no. 111, p. 1; Southern Sydney Retailers Association, submission no. 10; the Western Australian Farmers Federation, submission no. 106, p. 2.

61 Coles, submission no. 157, attachment A, p. 61.

Based on information provided to the ACCC during the inquiry, it appears that wheat (as opposed to flour, which is discussed later) accounts for between 5 and 10 per cent of the retail price of a loaf of bread.

Production of wheat and trends in key input costs

In Australia wheat is produced primarily in the wheat belt, which extends through central Queensland, New South Wales, Victoria, South Australia and south-west Western Australia. The Australian wheat industry comprises around 29 500 growers[62], generally producing around 25 million tonnes of wheat annually.[63] Most of this is exported with Australia representing between 10 and 15 per cent of the world's wheat trade.[64]

Both Agforce Grains and the WA Farmers Federation stated that real returns to grain farmers have been falling despite high wheat prices. They argued that farmers' inputs have also risen significantly, with the price of fertiliser doubling within 12 months and the most important chemical, glyphosate, tripling in cost.[65]

The supply of wheat to millers

Wheat is an internationally traded commodity and the price is largely set according to international supply and demand. Domestically, wheat used in bread production is sold to flour mills, both directly from farmers or through traders. One of the largest mills in Australia, Weston Milling, purchases about 70 per cent of its grain requirements from farmers, with the balance coming from traders.[66]

Given that grain producers export the majority of their produce, flour mills are effectively price takers. Agforce Grains submitted that the domestic grain market is transparent and effective, with farmers receiving prices that reflect supply and demand conditions.

Trends in the price of wheat

The recent rapid rise in the price of wheat has been well documented. Wheat prices reached record highs in both nominal and real terms in 2007–08.[67] The price of a tonne of wheat in Australia increased from $192 in 2005–06 to a forecast of $440 in 2007–08.[68] The rise in price occurred because demand for wheat has been growing in developing countries such as China and India, but supply has also been an issue.[69] Starting with low opening stockpiles, output has reduced due to poor seasonal conditions in many of the wheat producing regions such as the European Union and Australia.

12.4.2 Milling

Wheat is the essential raw input into flour milling. The flour milling process involves the wheat being cleaned, conditioned, ground, sifted and either transferred to bulk storage or packed. Flour mills supply to flour wholesalers and large retailers, bakeries, and large pasta manufacturers.

62 DAFF, Wheat Export Marketing Consultation Committee discussion paper, January 2007, p. 4.

63 ABARE, *Australian commodities*, March 2008, p. 33.

64 ibid.

65 Agforce Grains, submission no. 111, p. 3, and ACCC, public hearing transcript, Perth, 22 April 2008, p. 63.

66 George Weston Foods, response to informal information request.

67 ABARE, ibid.

68 ibid.

69 ibid.

Australia had around 25 flour mills in 2005, spread across all Australian states and in both metropolitan and country areas.[70] The key milling companies—Allied Mills, Weston Milling and Manildra—own multiple mills.[71]

The supply of flour to bread producers

There are two characteristics of flour milling that could potentially limit competition. The first is that some wholesale bread manufacturers are vertically integrated by also owning flour mills. However, the ACCC did not hear any complaints that non-integrated flour users had difficulty in obtaining flour at what they considered to be reasonable prices.

The second possible threat to competition in flour milling is that rationalisation within the industry could lead to the concentration of flour milling infrastructure in fewer hands. Rationalisation appears to be a response to the considerable under-utilisation of mills that has been reported in recent years.[72]

However, no evidence was presented to the inquiry to suggest that flour milling is not competitive. Bakers Delight stated that flour could be obtained at reasonable prices, even if prices would be lower if there were more players in the market.[73] The WA Farmers Federation stated that it believed the flour industry was competitive.[74] A 2004 report by the Department of Agriculture, Fisheries and Forestry (DAFF) also stated that the flour industry is highly competitive and that participants receive low margins.[75]

Trends in key input costs and the price of flour

Wheat is the main cost component in producing flour, with DAFF estimating that wheat and other ingredients account for around 60 per cent of total costs ex mill (excluding warehousing and distribution).[76]

The ACCC heard evidence that higher wheat prices are being passed directly through to higher flour prices. A number of suppliers of flour-based products confidentially advised the ACCC of frequent and significant increases in the price of flour of over 50 per cent over the last two years.[77]

12.4.3 Baking and distribution of bread

Different models of bread production

There are three models for the production of bread:

- bread wholesalers
- bakeries located within supermarket stores
- specialty bakery stores.

Bread wholesalers produce most of the branded loaves available in supermarkets, convenience stores and petrol stations. These manufacturers also produce private label bread products on behalf of the supermarkets.

70 Flour Millers Council of Australia, submission to the Agriculture and Food Policy Reference Group, May 2005, p. 1.
71 The Australian Wheat Board, accessed at www.awb.com.au/aboutawb/communityeducation/theflourmillindustry, 30 April 2008.
72 DAFF, *Price determination in the Australian food industry*, 2004, p. 74.
73 ACCC, public hearing transcript, Melbourne, 30 May 2008, p. 29.
74 ACCC, public hearing transcript, Perth, 22 April 2008, p. 6.
75 DAFF, *Price determination in the Australian food industry*, 2004, p. 74.
76 ibid., p. 78.
77 For an example of public comments, see Bakers Delight's comments, ACCC public hearing transcript, Melbourne, 30 May 2008, p. 27.

A number of MSCs have in-store bakeries. In-house supermarket bakeries commonly source partially prepared frozen or ambient product from the large bread wholesalers. This enables the supermarkets to offer freshly baked bread without having to produce bread from scratch in the manner of a specialist bakery.

Specialty bakery stores include independent hot bread shops as well as the Bakers Delight- and Brumby's-owned and franchised outlets. Strong growth of these franchises in recent years has depleted the quantity of sales of independent bakeries.[78] Bakers Delight now has over 600 stores and Brumby's over 300 stores in Australia.[79]

Distribution of bread

A number of considerations in distributing bread are not relevant in the distribution of other grocery items. The main restrictions on distribution systems are the demand for fresh product, the short shelf-life of bread and, consequently, the timely delivery of bread required for peak buying periods.

The need for freshness means that large bread wholesalers predominantly distribute their bread directly to supermarkets on the day of baking, rather than using supermarket distribution centres as is the case for most grocery items. It is common practice for bread producers to collect any bread that went unsold the previous day, with full refund for the retailer. Return loaves typically represent 5 to 15 per cent of sales.

Trends in key input costs

There are a range of inputs to the baking and distribution process, with the relative importance of each depending on the product and production method. Broadly speaking, the main input costs are ingredients, labour and overheads, followed by distribution and packaging.

Information (both public and confidential) provided to the ACCC suggests that flour accounts for approximately 5 to 15 per cent of the retail price of a loaf of bread. Bakers Delight stated that flour was the single biggest purchase it makes, but that it only accounts for approximately 20 cents of the $3.20 retail price of a standard white loaf.[80] So while the price of flour has definitely contributed to the increase in bread prices, it only partially explains any increase.

George Weston Foods submitted that grain and fuel were the main drivers of rising costs of production.[81] Another supplier made similar claims confidentially and pointed to increases in the prices of flour, gluten, transport, labour and energy. Bakers Delight said that the top five to ten individually significant ingredients in terms of cost had all recently gone up by at least 10 per cent.[82]

The supply of branded bread to supermarkets

Supply arrangements between wholesale bread producers and supermarkets differ depending on whether the producer supplies its own branded bread or private label bread.

Branded bread is sold to supermarkets like many other grocery items. A supplier will typically have a list price setting out the starting wholesale price available to all customers. Greater detail is provided in the

78 DAFF, *FoodMap: a comparative analysis of Australian food distribution channels*, 2007, p. 37.

79 Bakers Delight, accessed at www.bakersdelight.com.au/cms/document.php?objectID=151; Brumby's, accessed at www.brumbys.com.au/about/default.aspx. Both websites viewed on 30 April 2008.

80 ACCC, public hearing transcript, Melbourne, 30 May 2008, pp. 27–28.

81 George Weston Foods, submission 138, p. 10.

82 ACCC, public hearing transcript, Melbourne, 30 May 2008, p. 27.

trading terms mutually agreed to by both supplier and customer. The trading terms will describe many of the procedures by which supply is to occur, but most significantly the terms will specify discounts or fees.

The type and level of discounts and fees will depend on the advantages that the customer provides to the supplier, including business volume, promotional opportunities and the speed with which payment is made. Another determinant of price is further promotional activities which typically see the supplier pay the retailer to lower the retail price.

Trading terms will typically be more favourable to larger customers. George Weston Foods' submission discussed the benefits of dealing with the larger supermarkets:

> Broadly, MSCs offer national scale, reach and access to critical shelf space that smaller retailers cannot provide. This scale allows MSCs to drive larger volumes, influence and run promotional programmes independently and ultimately reduces the end price they are able to source product for. [83]

The eventual price paid by the retailer is affected by the relative negotiating power of each party, as discussed in chapter 14. George Weston Foods noted that it supplies its products through a variety of channels (such as wholesalers, major and independent supermarkets, convenience outlets, fast-food outlets and caterers) and each customer has a different level of bargaining power.[84]

Despite the many channels to retail customers available to bread producers, around 59 per cent of bread is sold through supermarkets.[85] As this figure includes bread sold through specialty bakery stores, supermarkets would account for a higher proportion of sales of bread produced by wholesale suppliers.

As a consequence, the MSCs are likely to have considerable buyer power in negotiations with bread manufacturers. For example, George Weston Foods claimed that any decision by the MSCs to cease purchasing from them would have significant ramifications for George Weston Foods' business.[86]

Further strengthening the ability of the MSCs to influence the terms of supply of branded bread is the rise in sales of private label bread, as discussed below, which means the MSCs are less reliant on branded bread sales.

Against this, both George Weston Foods and Goodman Fielder account for sizeable shares of total bread sales in supermarkets (28 per cent and 26 per cent, respectively[87]); they have also invested heavily in brand names that would be missed by consumers if they were removed from supermarket shelves. This is likely to give them a degree of countervailing power in any negotiations with the MSCs.

However, the balance of bargaining power in any negotiations between MSCs and smaller manufacturers is likely to be heavily weighted in favour of the MSCs. This was most notably illustrated in the case of *ACCC v Australian Safeway Stores Pty Ltd*.[88]

In this case the ACCC alleged that Safeway had a policy of removing a particular baker's products from sale when their products were on special at nearby independent stores. The ACCC alleged that the conduct of Safeway in ten separate incidents involved, among other things, price fixing and the misuse of market power.

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83 George Weston Foods, submission 138, p. 6.

84 George Weston Foods, response to informal information request.

85 Roy Morgan Single Source survey of grocery consumers, 2008.

86 George Weston Foods, response to informal information request.

87 George Weston Foods, response to informal information request.

88 *Australian Competition and Consumer Commission (ACCC) v Australian Safeway Stores Pty Ltd (N. 3)* (2001) 119 FCR 1.

On 30 June 2003 the Full Federal Court of Australia unanimously agreed that the ACCC had established that Safeway had engaged in price fixing.[89] The majority of the court also found that Safeway had misused its market power in four of nine incidents pleaded.

This case is discussed in detail in chapter 14.

The supply of private label bread to supermarkets

Supermarkets' private label bread products play an important role in the range of options available to consumers. According to Coles, the share of private label products in supermarket bread sales has increased from around 20 per cent in 2003 to nearly 50 per cent in 2007.[90]

The arrangements for the supply of private label bread differ from those for branded bread. Supply occurs under fixed contracts of one to two years. The contracts are generally awarded through an open tender process, although sometimes existing supply contracts are extended without a fresh tender process when both manufacturer and retailer are satisfied with the existing arrangements.

In awarding private label contracts, it appears that MSCs may prefer to award a single national contract for each bread product. Only two manufacturers can offer national coverage when tendering for contracts—George Weston Foods and Goodman Fielder.

Despite the limited choice of suppliers that can offer national coverage, the ACCC believes that the MSCs still have a degree of buyer power in sourcing private label product, given the volumes on offer and the importance of this supply channel to bread manufacturers. Further, while MSCs appear to prefer national contracts, they have the option of tendering on a state basis if they consider there is insufficient competitive tension in the national tender process.

The importance of private label contracts to manufacturers is reflected in the wholesale prices of private label bread supplied to the MSCs; these prices have remained relatively stable despite rising input costs and associated increases in the wholesale price of branded bread. This suggests there is strong competition among manufacturers to be awarded these contracts.

Trends in wholesale prices

The ACCC gathered confidential information about the wholesale price of selected breads sold in supermarkets. Different trends in wholesale prices were apparent for branded and private label bread.

The wholesale price of the selected branded bread remained stable or declined slightly between 2002 and early 2005, before increasing significantly over the last three years. This suggests that the suppliers of these branded breads have been able to pass on, at least in part, increases in the cost of production.

In contrast, the information gathered on selected private label bread products showed wholesale prices have generally remained stable over the last five years, indicating that suppliers have been more constrained in their ability to pass on increases in production costs than is the case for branded bread. Possible reasons behind this inability of suppliers to pass on increases in input costs include MSC buyer power, rigidity in contracts and strong competition among manufacturers to be awarded private label contracts.

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89 *Australian Competition and Consumer Commission v Australian Safeway Stores Pty Ltd* (2003) 129 FCR 339.

90 Coles, submission no. 157, attachment A, p. 41.

12.4.4 Retail supply of bread

The retail competitive environment

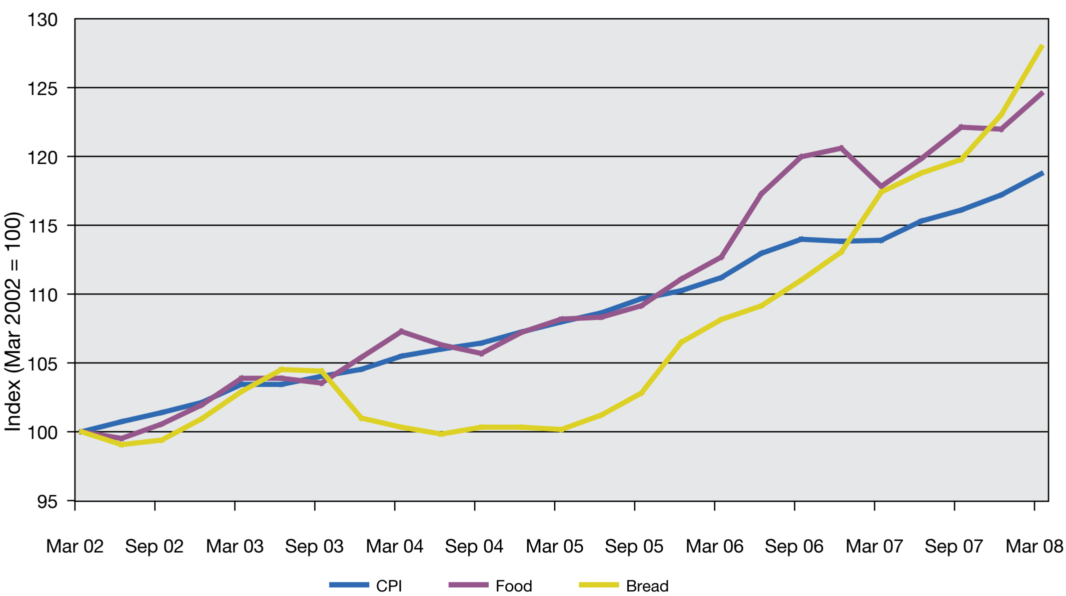
Bread is sold in a large range of retail outlets, including supermarkets, specialist bakeries, convenience stores and petrol stations. This creates stronger retail competition than for some other grocery items. While the majority of bread sales are made through supermarkets, their 59 per cent share of bread sales is smaller than for some other grocery items.[91] Specialty bakeries account for 31 per cent of bread sales, while 10 per cent of bread is bought from convenience stores.

The ACCC survey of grocery consumers found that people who mainly bought their bread from bakeries did so because they believed they were getting better quality products, better prices and a wider range of products.[92] Alternatively, people who made most of their bread purchases from supermarkets did so because they believed they were getting better prices, as well as minimising their travel time.

Trends in retail prices

Chart 12.9 contains data from the ABS that shows that nominal prices for bread in March 2005 were essentially the same as they were three years earlier. In contrast, prices for food and the CPI both grew at 7 per cent over this period. Since then, prices for bread have gone up substantially. Bread prices have leapt 28 per cent since March 2005, compared to more moderate growth in the price of food (15 per cent) and the CPI (10 per cent).

Chart 12.9 ABS CPI comparisons—all product groups, food products and bread



Source: ABS (cat. no. 6401.0)

91 Roy Morgan Single Source survey of grocery consumers, 2008.

92 ACCC, survey of grocery consumers, 2008.

The ACCC analysed confidential information showing the retail price trends of specific bread products. The retail prices of the specific branded bread products examined demonstrated a similar trend to the ABS data. Prices were relatively stable between 2002 and early 2005, before increasing significantly in the last three years. However, the specific private label bread products considered by the ACCC did not exhibit the same trends as the branded bread products or the ABS data. Broadly, prices of these products at the end of 2007 were very similar to those in 2002.

The result is that consumers purchasing private label bread from supermarkets have not been exposed to any significant price increases over the last five years. However, purchasers of branded bread have experienced significant price increases since 2005. One consequence of this is that price sensitive consumers have switched to private label products to avoid these price increases.

Other consumers are paying more for bread as a consequence of consumer preferences shifting to bread types with higher production costs. Bread varieties now include fortified bread, gluten-free, additional iron, high fibre, low GI, soy and linseed, oat bran and honey, and bread with fruit.

Retailer gross margins

The ACCC obtained various confidential data showing that the gross margins obtained by retailers in bread varied significantly. The most important factor influencing margins appears to be the degree to which the retailer wishes to use cheap bread to attract customers. The strategy of using low-cost bread to attract customers means that simply observing gross margins does not necessarily provide an insight into whether a particular player has a degree of market power.

This is particularly true for private label bread, where the relatively low wholesale price provides the retailer with the opportunity either to obtain high margins or sell very cheap bread. ALDI in particular was driving competition in this area with loaves for sale at 99 cents for a number of years (ALDI recently increased the price to $1.09).

Margins are generally lower for private label bread than branded bread, which suggests retailers are prepared to offer private label product at lower prices to attract customers. This practice is likely to create competitive pressure on cheaper branded products. Although both wholesale and retail prices for specific private label bread products have remained relatively stable over the past few years, there has been sufficient movement in wholesale prices for retail margins to decline slightly.

Confidential information gathered by the ACCC through the inquiry and other activities suggests that retail gross margins for branded bread range from 0 to 40 per cent of the retail price. Larger supermarket chains typically operate with margins of approximately 30 per cent, while smaller retailers are more likely to be operating at margins of 20 per cent. There were no widespread trends in gross margins relating to the specific branded bread products considered by the ACCC. The gross margins were increasing on some bread products and declining on others.

12.4.5 Conclusion

As an overall category, the price of bread has risen substantially since March 2005, outpacing both the price of food generally and the CPI. However, prices for private label bread have remained relatively flat, which has resulted in many consumers switching to private label bread to avoid higher prices.

While the rising prices of bread reflect increasing production costs, the impact of increases in the cost of wheat on bread prices has been overstated. More generally, it appears that some of the observed increasing costs have been absorbed by manufacturers rather than being passed on in wholesale prices.

Particularly in respect to private label bread, it appears that the buyer power of MSCs and strong competition between manufacturers has kept wholesale prices low, allowing retailers to offer these products at low retail prices to attract customers.

There also appears to be strong competition at the retail level, particularly among supermarkets in respect of cheaper bread products.

12.5 Eggs

Key points

- The price of the cheapest dozen eggs sold through the MSCs in 2003 was approximately $2.40.[93]
- The price of the cheapest dozen eggs sold through the MSCs in the first quarter of 2008 was approximately $2.65.[94]
- This increase in the price of the cheapest dozen eggs is less that the rate of increase in the CPI over the same period. However, the rate of increase in the price of eggs overall has been greater than the increase in the CPI over this period.
- Retail sales of eggs account for around 50 per cent of all shell eggs produced, with the foodservice sector accounting for the remainder. Approximately 50 per cent of these retail sales of shell eggs are through the MSCs. Up to 70 per cent of the MSCs' egg sales are private label.
- The price of feed grain, which represents in excess of 50 per cent of producers' variable costs, has increased by 132 per cent since 2005, significantly increasing overall egg production costs. There has been a significant shift in consumer preferences from branded to cheaper private label eggs in recent years.
- Consumer preferences have also shifted towards barn laid and free range eggs, and 'value added' eggs such as organic eggs. These eggs are more costly to produce and, consequently, consumers who have made this switch are paying significantly more for their eggs.
- The MSCs have a degree of buyer power, particularly in respect of sourcing eggs to sell under their private label brands. This is reflected in lower producer and retail prices for private label eggs.
- There appears to be strong competition at the producer level both for the supply of branded and private label eggs.

12.5.1 Introduction

Eggs are either sold as whole 'shell' eggs to retail outlets and the food service sector, or as egg product (including frozen, liquid or powdered egg), sold predominantly to the food service sector.

The primary focus of this case study is shell eggs sold through retail channels. However, a producer's ability to switch between supplying retail outlets, food service providers and manufacturers of egg products is relevant to a consideration of issues of buyer or seller power through the supply chain.

93 This figure is a national average based on information provided by Woolworths.

94 This figure is a national average based on information provided by Coles and Woolworths.

12.5.2 Structure of the egg industry in Australia

The gross wholesale value of eggs produced in Australia in 2006–07 was $398 million, up from $375 million the previous year.[95] Australians consumed three billion eggs in 2005–06, which were sourced from 423 egg producers from a brood of over 16 million hens Australia-wide.[96] Shell eggs represent around 45 to 48 per cent of total egg sales, with sales to the food service industry, predominantly of egg product, taking up the remainder.[97] Of the national supermarket shell egg sales, Coles' and Woolworths' share is estimated at up to 70 per cent.

Historically, egg production in Australia was controlled by state-based statutory egg boards that regulated both the marketing of eggs and the setting of production quotas to control the level of supply. Deregulation was introduced progressively across Australia, starting with New South Wales in 1989. Egg production in Western Australia was not deregulated until 2005. Egg production in Australia is predominantly located close to major population centres, and over 50 per cent of producers are located in Victoria and New South Wales.

In the latter part of the twentieth century the egg industry experienced a downturn, which was attributed to changing dietary habits caused by health concerns that egg consumption led to cholesterol problems and heart disease. At the same time there was a change in consumer preferences, with an increase in sales of free range eggs likely driven by concerns for animal welfare. By 2005–06 free range eggs represented 23 per cent of retail egg sales.[98]

Australia has little overseas trade in eggs and quarantine restrictions prevent the importation of shell eggs. Some egg product is imported from countries such as New Zealand. The value of egg product imported in 2005 was comparatively low at $6.5 million. The value of exports was lower again at $2.2 million.[99]

The supply chain

Chart 12.10 shows a diagram of the functional levels of the Australian egg industry.

There are only two functional levels in the egg supply chain, the producer and the retailer. Among producers, there are varying degrees of vertical integration. Some producers focus purely on egg production, while others are also involved in other functions including grading and packaging.

Since deregulation, concentration of production in the egg industry has increased. Today the industry consists of a few large producers, complemented by a larger number of medium and smaller producers.

The largest egg producer in Australia is the New South Wales-based Pace Farms, followed by the Victorian producer, Farm Pride. Farm Pride and major producers from several other states established a joint marketing venture, NOVO Foods, with the responsibility for marketing their products to the MSCs.

95 ABS, *Principle agricultural commodities produced*, preliminary cat. no. 7501; and ABS, *Value of agricultural commodities produced*, cat. no. 7503.

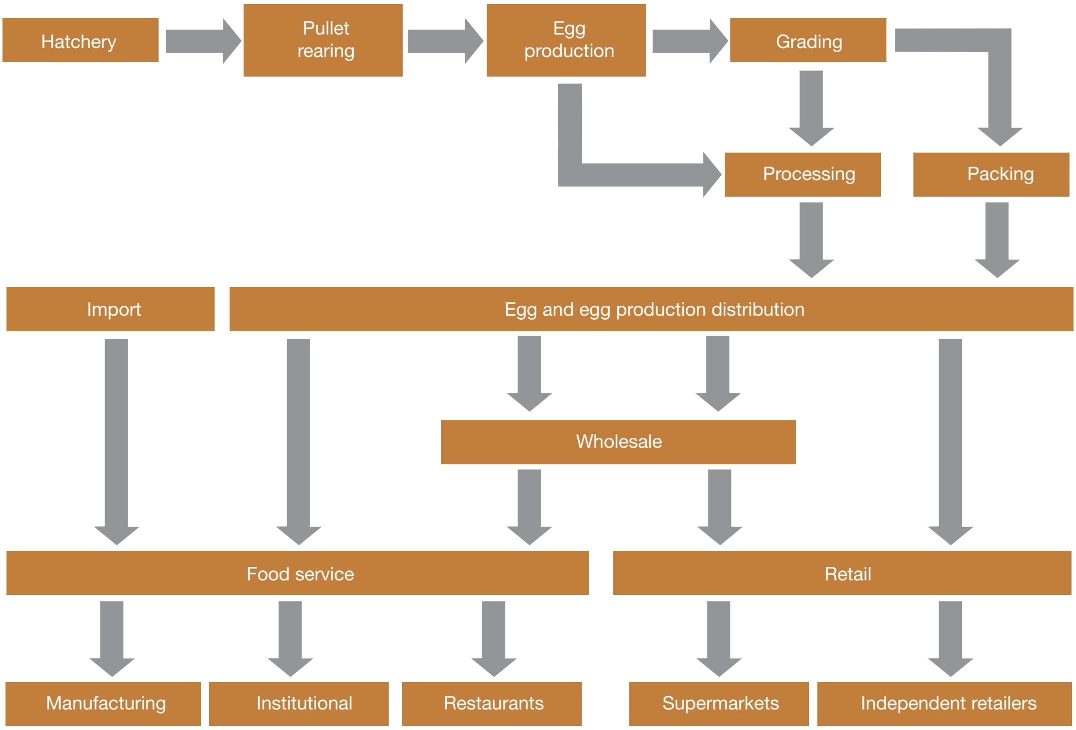
96 Australian Egg Corporation Limited (AECL), *Annual report 2007*, p. 4.

97 AECL, submission no. 113, p. 4.

98 AECL, *Annual report 2007*, p. 3.

99 ibid.

Chart 12.10 The Australian egg industry



Source: AECL submission no. 113, p. 3

Shell eggs are produced by several different methods, including cage, barn-laid and free range, and are usually sold through retail outlets such as supermarkets, convenience stores and specialty retailers. Table 12.2 shows the breakdown of retail sales of shell eggs by the three methods of production for 2005–06.

Table 12.2 Retail sales of eggs by method of production in 2005–06 (per cent)

	Volume	Value
Cage eggs	71.4	61.1
Barn laid	5.3	6.9
Free range	23.4	32

Source: AECL, *Annual Report 2007*, p. 4.

12.5.3 Egg production

This section examines the egg production process.

Input costs to egg production

The different methods of egg production have different cost structures, with free range eggs being significantly more expensive to produce. A study by the Rural Industries Research and Development

Corporation in 2002 estimated the respective costs of production for a dozen 700gm eggs to be[100]:

- cage eggs $1.25
- barn eggs $1.70
- free range eggs $2.15.

While these figures are somewhat dated, they illustrate the relative cost of producing different types of shell eggs.

The major variable cost in the production of eggs is feed grain costs, which represents in excess of 50 per cent of a producer's variable costs and more than 30 per cent of the retail price of eggs.

Egg producers have faced significant increases in the cost of grain in recent years with evidence provided to the ACCC showing feed costs more than doubling since 2005.[101] This increase in the cost of grain has been attributed to various factors, including drought conditions in Australia and increasing global demand for biofuels. The Australian Egg Corporation Limited (AECL) stated that the feed costs to produce a dozen eggs have recently increased by 40 cents, but the impact on retail prices has been delayed because egg producers have entered forward contracts for grain.[102]

According to the AECL, the other major variable costs of producing eggs are labour, pullets (young birds) and packaging, all of which have been increasing in cost in recent years. The increasing cost of fuel and transportation has also added to cost pressures faced by egg producers.

Determinants of producer price

Shell eggs are a commodity with little product differentiation (other than by production method) possible at the producer or retail levels. Evidence presented to the ACCC shows that the price paid to producers varies with the level of supply and demand. As there is a significant lead time before birds produce eggs, producers have limited ability to change their level of output quickly in response to changes in market conditions.

In a period of over-supply, a producer may offer promotions to the MSCs in an attempt to maintain market share or may try to sell more product through other avenues such as food service. Alternatively, a producer may process the shell eggs into egg product, which usually attracts a lower price.

The AECL submitted that the domestic market is also affected by the price of imported egg products. It submitted that domestic manufacturers of egg powder cannot compete on cost with overseas manufacturers and that therefore:

> … imported powder does displace the local manufacture of powder forcing more fresh shell eggs onto the Australian market increasing supply and hence placing downward pressure on egg prices.[103]

Supply arrangements with supermarket chains

The majority of eggs supplied to the MSCs are supplied by the larger vertically integrated producers that are responsible for the rearing of the chicks, egg collection, grading and packing. These larger producers often supplement their own supply by purchasing eggs from smaller producers. Once

100 DAFF, *Price determination in the Australian food industry,* 2004, p. 89. The ACCC recognises that since the publication of the DAFF report, there have been significant shifts in costs and that these figures may not reflect more recent changes in the relativities between the cost of each method of production.

101 AECL, submission no. 113, p. 6.

102 Food Week, no. 1919, 2 May 2008, p. 15.

103 AECL, submission no. 113, p. 5.

packed, the eggs are transported to the retail distribution centres in pallet quantities and title passes to the MSC upon acceptance of the goods received.

Supply terms and conditions differ depending on whether proprietary branded or private label eggs are being supplied. The MSCs usually seek tenders for the supply of private label product on a regional basis. This allows producers who would not have the capacity to supply an entire state to respond to a tender. Eggs sold under private labels will usually be packed and delivered by the supplier according to requirements set out by the MSC. Contracts for the supply of private label eggs usually last 12 months and stipulate a set price for the duration of the contract. Despite the private label contracts stipulating a buy price, the ACCC is aware of instances where MSCs have agreed to an intra-period price increase in circumstances where the contracted party has experienced significant cost increases.

For proprietary branded eggs, the major producers have set price lists, but deviate from these prices in response to market conditions. Given this price flexibility, producers have a greater ability to pass on costs in a timely manner through their branded product than through private labels. However, evidence provided to the ACCC indicates that, in practical terms, producers are constrained in how much they can increase the price of branded product because of the presence of the competing private label product.

Information provided confidentially to the ACCC indicates that the terms of trade between the MSCs and the large producers have not changed significantly over recent years. This suggests that the relative bargaining positions have not changed.

Producer prices

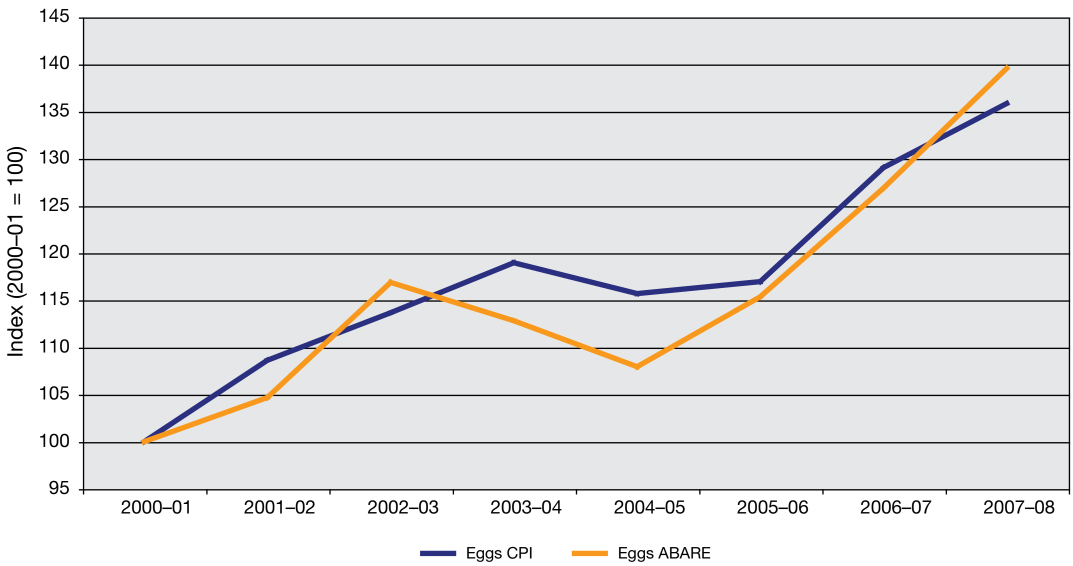
The ACCC has obtained evidence from egg suppliers and the MSCs on wholesale egg prices.

While there is significant variation across states, producers and product, the average price received by producers for a carton of 700gm branded caged eggs has increased from approximately $2.00 in 2006 to approximately $2.50 in early 2008. Over the same period, the average price received by producers for 700gm cage eggs sold under private label has increased from approximately $1.70 to approximately $2.30.[104]

Chart 12.11 plots an index of producer and retail prices for eggs for the period from 2000–01 to 2007–08. The figure highlights that the retail price of eggs has closely tracked producer prices over the period. Further, it shows that both price series have risen steadily, except for a period of decline in 2002–03 to 2004–05. Changes in the retail price of eggs are examined in more detail below.

104 Figures displayed are aggregated to an extent that no conclusion can be drawn regarding the amount any retailers paid for any one particular product.

Chart 12.11 Index of producer prices and retail prices for eggs (2000–01 to 2007–08)



Source: ABARE, *Australian commodity statistics*, 2007, pp. 22–23; ABARE, *Australian commodity statistics*, March 2008; ABS, *Consumer price index, Australia*, catalogue no. 6401.0, March 2008

Differences between prices on branded and private label products

As stated above, information provided to the ACCC indicates that producers receive a higher price for proprietary branded products compared with private label products. This may be due to factors such as:

- Lower costs associated with suppling private label products—for example, some suppliers only supply private label eggs and therefore do not have the overhead costs associated with promoting and maintaining a branded product.
- As private label contracts often have a 12-month duration and stipulate a sale price, it is more difficult for a producer to increases price during the life of the contract—for example, in response to rising input costs.

Another reason suggested for the difference in wholesale prices for branded and private label eggs is the buyer power of the MSCs. Private label eggs sold through the MSCs represent a significant volume of all shell eggs sold through retail channels. Accordingly, failure to secure some of this business would be likely to impact significantly on any large producer. It appears that the importance of these contracts to egg producers is reflected in the lower wholesale price at which the MSCs are able to source eggs for sale as private label product.

12.5.4 Egg retailing

This section examines the retail sale of eggs.

Retail price of eggs

There are two characteristics of egg products that lead to price differences on the retail shelf:

- method of production (cage, barn and free range)
- whether the egg is private label or proprietary branded.

Along with proprietary branded eggs, MSCs stock two tiers of private label eggs. The cheapest private label products are Homebrand (Woolworths) and Smart Buy (Coles). A carton of a dozen cage Homebrand or Smart Buy eggs currently sells for approximately $2.65. The next tier of private label caged egg products sold by the MSCs includes You'll Love Coles and Woolworths Select, which are both priced at approximately $3.35.[105] The price of a dozen branded cage eggs sold through the MSCs currently ranges from approximately $3.90 to $4.50.[106]

According to the AECL, in 2007 private label eggs represented 61 per cent of all eggs sold at retail[107], and evidence presented to the ACCC indicates that private label sales through the MSCs may be as high as 70 per cent. The increasing share of sales through the MSCs held by private label is a relatively recent development. Sunny Queen submitted that, over the last five years, the private label eggs produced by Sunny Queen had increased from 20 to 80 per cent of its total egg production.[108]

The growth has been primarily driven by the lower prices at which the MSCs purchase private label eggs, which is reflected in retail prices.

Focusing specifically on the cheapest private label caged eggs available through the MSCs, the current average retail price of approximately $2.65 compares with an average price of approximately $2.40 five years ago. This represents an increase of approximately 10 per cent. Over the same period general inflation was 14.8 per cent[109], meaning that the retail price of the cheapest dozen eggs sold by the MSCs has increased at a rate below the CPI.

Despite this relatively modest increase in the price of lower tier private label eggs sold through the MSCs, retail prices for eggs generally—as measured by the ABS—have increased at a rate above the CPI in the last couple of years.

105 This figure is a national average for 700 gm eggs and will vary between states.

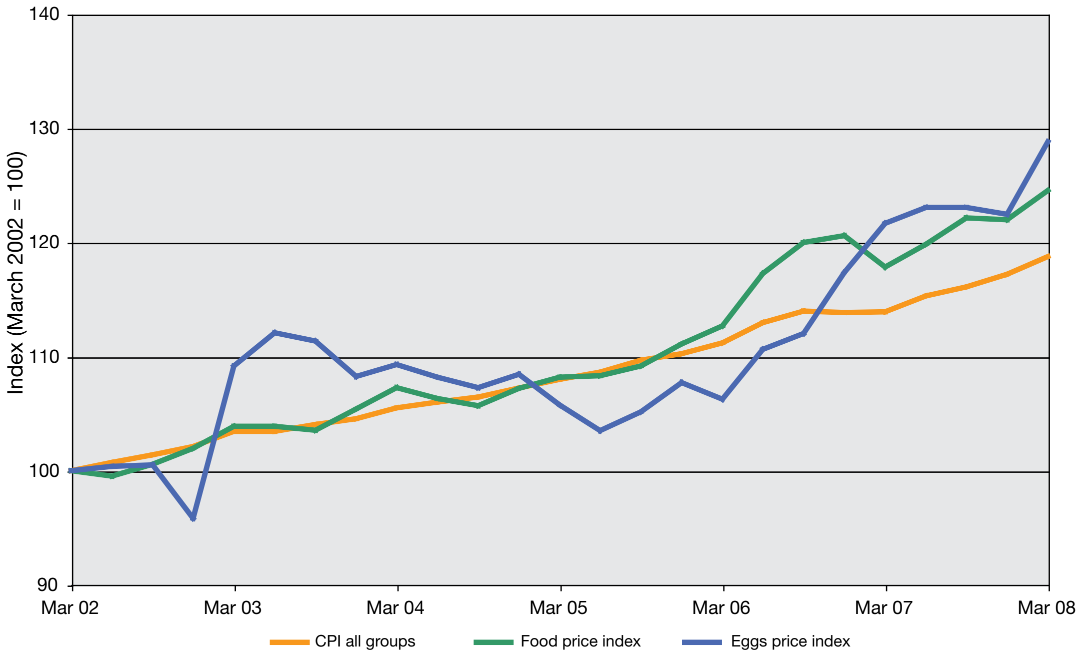
106 These figures are snapshots only and do not attempt to capture the price of every branded caged egg product.

107 AECL, *Annual report 2007*, p. 3.

108 ACCC, public hearing transcript, Melbourne, 2 June 2008, p. 5.

109 Overall CPI from March 2003 to March 2008.

Chart 12.12 ABS CPI comparisons—all product groups, food products and eggs



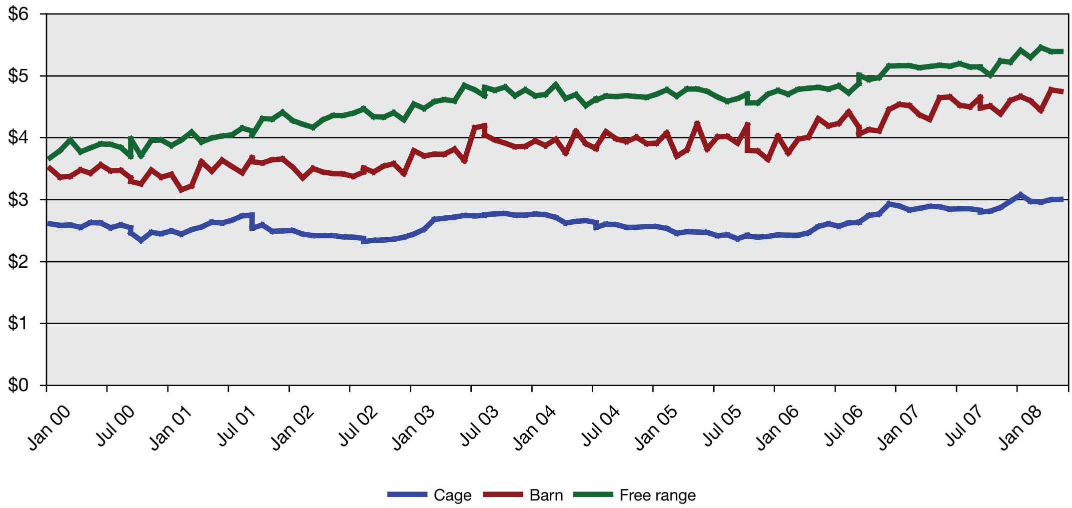
Source: ABS, *Consumer price index, Australia*, catalogue no. 6401.0, March 2008

Between 2002 and 2007, the average annual increase in the retail price of eggs was 4.3 per cent, compared with a 3.7 per cent annual increase in overall food prices and a 2.7 per cent annual increase in the CPI. As illustrated, retail egg prices have increased significantly in the last 18 months. This recent upward trend in the relative price of eggs is not unexpected given the significant increases in input costs faced by egg producers.

Chart 12.13 shows that the rate of increase in the retail price of eggs has varied across cage, barn laid and free range eggs. Prices of barn laid and free range eggs have increased significantly more than cage laid eggs over the period, although the nominal price of free range eggs has decreased since 2003. The AECL has attributed this decline in nominal prices of free range eggs to market saturation of this egg category.

The data suggests only modest increases in the nominal price of cage laid eggs as a category.

Chart 12.13 Nominal retail prices for eggs by method of production



Source: AECL submission, p. 19 (incorporating updated data provided by the AECL)

Movements in retailer margins

During the inquiry the ACCC sought information regarding gross margins from the MSCs and other retailers. The MSCs' gross margins on eggs fluctuate from year-to-year and across states. While there has been considerable fluctuation in margins over recent years, there does not appear to be a discernable upwards or downward trend in these margins.

The MSCs appear to make lower margins on the high volume egg products such as caged eggs and a greater margin on the more expensive 'value added' products like barn laid and free range eggs.

Gross margins on private label caged eggs, where most of the volume lies, varied between the two tiers of private label eggs, with the higher priced private label product attracting a higher gross margin than the cheaper private label product. This is not surprising given that there is often little difference between the two tiers of private label product and accordingly they are often sourced at similar wholesale prices. Gross margins on proprietary branded eggs were above those for the higher priced private label eggs.

12.5.5 Conclusion

The egg industry has undergone significant change in the past decade with an increase in sales of free range eggs because of animal welfare concerns and shifts in consumer preferences to value added eggs such as organic eggs. At the same time, consumer preferences have shifted away from branded eggs towards private label eggs, with private label product now making up over 60 per cent of all retail shell egg sales.

The cost of producing eggs has increased significantly in the last couple of years, most notably because of escalating feed costs.

There is strong competition at the processor level, particularly in respect of the MSCs' private label contracts. Given that private label eggs sold through the MSCs represent approximately half of all shell eggs sold through retail channels, the MSCs have a degree of buyer power in sourcing private label eggs that is reflected in lower wholesale, and retail, prices for private label eggs.

The price of eggs, as measured by the ABS, has increased at a rate faster than the CPI, and food prices in general, over the last two years. This is primarily a reflection of rising production costs. However, for the many consumers who have switched from branded to private label eggs, the increase in the price paid for eggs over this period will be lower than the overall increase in prices in the egg category.

12.6 Nappies

Key points

- In 2002, the average shelf price in the MSCs for a Jumbo pack of leading brand Huggies was in the range of $37 to $38, while in 2007 the average price was in the range of $33 to $35.[110]
- Supermarket share of nappy sales has increased significantly over the last 20 years.
- Brand loyalty means that private label nappies only account for around 10 per cent of nappy sales through the MSCs.
- Consumers are generally more price sensitive in respect of nappies than many other grocery purchases. Reflecting this, there is strong competition among supermarkets and other retailers selling nappies.
- Huggies are often sold by supermarkets at heavily discounted prices, sometimes below cost, in order to attract customers into stores.

Disposable nappies for children are an important and costly single element of the grocery basket for many families with young children in Australia. Disposable nappies are generally produced in six sizes that cater for children as they grow—newborn, infant, crawler, toddler, walker and junior.

12.6.1 The supply chain

The supply chain for nappies is simpler than for most products. Producers in the nappy industry sell their product direct to the wholesaler or the MSC and the product is delivered to the warehouse before being distributed to retail stores.

Nappy manufacturers and brands[111]

Kimberly-Clark is the largest producer of nappies in Australia with manufacturing facilities located throughout south-eastern Australia. Kimberly-Clark produced 78 per cent (by retail value) of all nappies sold in Australian supermarkets in 2007 (excluding sales through ALDI stores). This figure is up from 72 per cent in 2001.

Kimberly-Clark produces the Huggies brand, which accounted for 67 per cent of nappy sales in supermarkets in 2007, up from 52 per cent in 2001, and the Snugglers brand, which accounted for 10 per cent of supermarket sales in 2007, down from 13 per cent in 2001.

DSG Pty Ltd, trading as Australian Pacific Paper Products (APPP), is the second largest nappy producer in Australia; it manufactures proprietary and private label disposable nappies for Australian and overseas markets from a facility in Melbourne. APPP had approximately 15 per cent of nappy sales

110 Kimberly-Clark response to s. 95ZK notice, cited with consent from Kimberly-Clark.

111 The figures for this section have been obtained from *Retail World's Australasian Grocery guide*, Barry Flanagan (Ed.), and relate only to supermarket sales. Figures exclude ALDI.

through supermarkets in 2007, with its Babylove brand constituting around 11 per cent of sales, which is approximately the same share of sales it had in 2001.

Private label products constituted around 10 per cent of supermarket nappy sales in 2007, up from 8 per cent in 2001. If sales through ALDI stores are included, the ACCC considers that the percentage of private label nappy sales through supermarkets would be higher, given ALDI's focus on private label products.

Woolworths offers two tiers of private label nappies: the lower priced Homebrand and the (comparatively) higher priced Select brands. Coles, by comparison, offers a single private label range of nappies under its You'll Love Coles label.

Category share of other brands has fallen over the six years to 2007 to be less than 2 per cent of sales through supermarkets in 2007, primarily because of the growth in sales of Huggies and, to a lesser extent, private label products.

Input costs and trends in input costs[112]

Most disposable nappies are produced using a combination of materials, including paper pulp, non-woven materials, tapes, flaps, elastics and fastening materials. Inputs may be sourced locally or from overseas. Cardboard and plastic is also used in the packaging of nappy products. However, some nappies are produced using different combinations of inputs. For example, the outer layer of Nature Babycare nappies is manufactured using maize instead of plastic.[113]

Information provided to the ACCC by nappy producers indicates the contribution of the various inputs and other costs to the total cost of production varies according to the type of nappy and from producer to producer. The ACCC has aggregated data from a number of producers to give an approximate range of the proportion of the production cost of nappies attributable to each factor of production.

Information provided to the ACCC indicates that raw materials, including pulp fibre, absorbents, base materials, and other materials such as fastening devices and elastics account for approximately 60 per cent of the production costs associated with nappy production in Australia.

In the past 12 months, the cost of importing pulp and/or fibre has increased by around 10 per cent as a result of, among other things, increased demand from China and India. However, the cost of some other imported inputs has fallen over the same period because of the appreciation of the Australian dollar.

Labour is another significant cost associated with the production of nappies, accounting for approximately 10 to 15 per cent of production costs. Nappy producers indicated that staff wages have increased by approximately 5 to 10 per cent over the last two years.

Maintenance on machinery varies from manufacturer to manufacturer depending on factors such as the age of the machinery. The figures provided to the ACCC indicate that maintenance costs account for approximately 5 per cent of the retail price of a nappy. Producers of nappies also experience depreciation of approximately 5 per cent on the assets required for production.

Packaging, including cardboard and plastic, accounts for approximately 5 per cent of the cost of producing nappies. Nappy producers advised that packaging and cardboard costs have been steady in recent years.

112 Information in this section has been sourced from confidential information provided by nappy producers and is cited with their consent.

113 Nature Babycare, www.naty.com, viewed 22 July 2008.

Freight also accounts for up to 10 per cent of the production cost of nappies. Freight costs have been increasing recently due to rising fuel costs.

Other factors such as insurance, consultancy, office and travel expenses make up the remaining portion of the production costs.

12.6.2 Negotiations with retailers

Nappies may be supplied to supermarkets under supply agreements for branded products or under contract for private label products. Branded products are generally supplied on trading terms, which involves the producer setting a list price that is a starting point from which rebates and other fees are deducted by the retailer for promotional and advertising costs, settlement allowances, business volume rebates and other activities associated with the sale of the product.

Private label nappies are supplied under contract, often for fixed terms. These contracts specify the quality specifications of the required product, price and other trading terms.

The share of nappy sales through supermarkets has increased significantly in recent years. For example, Kimberly-Clark stated that in 1984 significantly more than 50 per cent of its nappies were sold through channels other than the MSCs. This included sales through stores such as pharmacies, Toys 'R' Us, Kmart, Big W, hospitals and small stores. By 2007 around 70 per cent of Kimberly-Clark nappies were sold through the MSCs.[114]

This shift in where consumers purchase nappies has been driven in large part by the MSCs' use of nappies as a loss-leading product to attract customers. In particular, supermarkets will often sell Huggies on promotion at prices close to or sometimes below cost in order to attract customers.

Given the large share of nappy sales made through supermarkets, producers are heavily reliant on their relationship with the MSCs. Smaller manufacturers are therefore likely to be in a comparatively weaker bargaining position now than they were when they relied less on sales through the MSCs. However, the relatively low level of private label nappy sales, compared with many other grocery items, suggests that consumers do expect to see a range of nappy products for sale, including the premium brands. As a key item that attracts consumers to stores, producers of products with strong brand recognition will have some countervailing bargaining power in negotiations with the MSCs.

Kimberly-Clark in particular, with its strong Huggies brand, is likely to have significant countervailing power in its negotiation with the MSCs. While the MSCs are a vital retail distribution channel for Kimberly-Clark nappies, Kimberly-Clark's Huggies brand is also very important to the MSC's because it has strong recognition and brand loyalty among supermarket customers. The MSCs use of Huggies price promotions to attract customers further underpins the importance of the Huggies brand to them.

12.6.3 Retail prices and margins

The retail price of nappies varies depending on a range of factors, including the number of nappies in the packet, the size of the nappy, the brand, whether the product is being sold on discount and the retailer from which the nappy is purchased.

The different size nappies and size of packets makes direct comparison of prices difficult. However, the comparisons undertaken do suggest that private labels are sold at a lower price than branded nappies. A packet of Woolworths Select Toddler 24's and the You'll Love Coles Toddler 24's costs approximately

114 Kimberly-Clark response to s. 95ZK notice, cited with consent from Kimberly-Clark.

$13 to $14. The premium Huggies Toddler 24's packet costs in the range of $16 to $17.

There are also differences in the price of branded products. Comparing branded products, Huggies' Junior 30's costs in the range of $22 to $23, Babylove Junior 30's costs in the range of $20 to $21, and Nature Junior costs in the range of $22 to $24.

Prices will vary outside these ranges due to promotions.

Nappies are only purchased by one segment of grocery shoppers: parents with small children. However, for these customers, nappies are one of the highest cost products in their grocery shopping basket. As such, consumers are generally more price sensitive in respect of nappy purchases than most other grocery items.

In recognition of this, supermarkets often engage in heavy price promotions on nappy products to attract customers. In particular, supermarkets will often run promotional specials on the leading Huggies range, pricing the product at close to or below the cost of supply. One retailer provided evidence to the inquiry that a reduction in the price of Huggies nappies from $38 to $28 for a one-week promotional period in 2008 resulted in a 40-fold increase in sales.

This use of nappies as a key value item to attract customers into supermarkets means that price competition at the retail level on nappy products is particularly strong and any retailer seeking to increase prices on nappy products would be likely to quickly lose business to their competitors.

Margins

With the exception of Huggies, gross margins, measured as the difference between the retail and wholesale price of the product, for nappy products sold through the MSCs on which the ACCC obtained information were generally in the range of 25 per cent to 30 per cent.

As would be expected, given the heavy promotional discounting of Huggies nappies that regularly occurs, gross margins on Huggies nappies were much lower than this. Gross margins fluctuated significantly across time and between states but were generally less than 10 per cent and occasionally negative.

12.6.4 Conclusion

- Kimberly-Clark is the largest supplier of nappies in Australia, accounting for approximately 70 per cent of the nappies sold in Australian supermarkets, including the leading Huggies brand.
- Reflecting strong consumer loyalty to the Huggies brand, Huggies is often sold by supermarkets at heavily discounted prices, sometimes below cost, in order to attract customers to the store.
- Brand loyalty among consumers also means that private label nappies only account for around 10 per cent of nappy sales through the MSCs.
- More generally, nappies are one of the highest cost products in the grocery shopping basket of many consumers. As such, consumers are generally more price sensitive in respect of nappy purchases than most other grocery items. Reflecting this, there is strong competition among supermarkets and other retailers selling nappies.

12.7 Biscuits

Key points

- After increasing at a rate well below CPI and the general food category from 2002 to 2005, biscuit and cake prices have increased by around 17 per cent over the last three years. This is slightly higher than the rate of increase in general food prices and significantly above the CPI.
- Recent price increases appear to reflect increases in the cost of manufacturing biscuits.
- Strong brand recognition means that private label products are not nearly as prevalent in the biscuit category as in many other grocery item categories.
- Compared to other grocery items, a high proportion of biscuits are sold in supermarkets, which would ordinarily place the MSCs in a strong position when negotiating with suppliers. However, the buyer power of supermarkets is mitigated to some extent by the strong brand recognition that some biscuit brands enjoy.
- Arnott's in particular is likely to have countervailing power in negotiations with the MSCs as a consequence of its dominant share of biscuit sales and strong brand names such as Tim Tam.
- Overall, it does not appear that biscuit manufacturers are significantly constrained in their ability to pass on increases in costs of production by the buyer power of the MSCs.
- Where biscuit manufacturers do not pass on their increased production costs in full, it appears that this is partly due to strong competition between manufacturers and a desire to see their brands remain price-competitive on supermarket shelves.

Biscuits come in different varieties, including chocolate, sweet and savoury. Dry packet biscuits have a long shelf life and are distributed in much the same way as other dry groceries. The supply chain for biscuits has only two main stages: biscuit production and retailing.

12.7.1 Wholesale supply of biscuits

Arnott's is the largest supplier in the $1.1 billion Australian biscuit industry.[115] Its products span the whole range of biscuit varieties. Arnott's produces biscuit brands including Tim Tam, Chocolate Royal, Mint Slice, Iced Vo Vo, Tiny Teddy, Scotch Finger, Monte Carlo, Nice, Granita, Salada, Sao and Vita Wheat.

The next largest biscuit producers in Australia are Paradise Foods and Kraft, although both are much smaller biscuit producers than Arnott's. Paradise Foods produces the Cottage, Vive and Veri Deli brands, as well as biscuits under contract for Woolworths, Coles, ALDI, Kellogg's and Nestle. Paradise Foods has recently been bought by one of Australia's largest food companies, Goodman Fielder. Kraft produces the Oreo and Nabisco brands.

The relatively long shelf life of biscuits means suppliers can take advantage of economies of scale by producing biscuits for sale throughout Australia at centralised locations. The importance of scale in the production of the biscuits was demonstrated by Kraft's decision in early 2006 to cease producing locally and instead consolidate production at a large plant in China.

115 Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2008*, Retail Media, Sydney, 2008, p. 63.

Trends in key input costs

Confidential information provided to the ACCC indicated that ingredients account for approximately 15 to 25 per cent of the retail price of biscuits. Flour, cocoa (for chocolate biscuits), dairy, sugar and oil are all important for biscuit production.

The ACCC understands that the costs associated with many of these inputs have been rising significantly. As described in the bread case study earlier in this chapter, flour prices have been rising because the price of wheat has increased from $192 a tonne in 2005–06 to a forecast $440 a tonne in 2007–08.[116] The effect of wheat price rises on the price of flour is explored in the bread case study. A number of suppliers of flour-based products confidentially advised the ACCC of frequent and significant increases in the price of flour, amounting to an increase of more than 50 per cent over the last two years.[117]

Confidential information from a supplier showed substantial price rises in dairy, sugar and flour, while Paradise Foods told the inquiry hearings of increases in the prices of butter, shortening and palm oil.[118] Producers identified labour, overheads, packaging, distribution and warehousing as other major costs in manufacturing.

Supply arrangements with supermarkets

Biscuits are sold to supermarkets in a similar manner to other grocery products. For proprietary brand biscuits, each supplier has a price list specifying the starting wholesale price that applies to all customers. The list price is generally a single price, although Arnott's has recently announced that its list prices will be subject to a service charge or discount dependent on the volume of product purchased in any single order.[119]

While the list price applies to all customers, it is generally only a starting point for negotiations. More detailed trading term arrangements are negotiated between the manufacturer and each customer. These trading terms include rebates and discounts provided to the retailer in return for matters such as display support, participation in promotional programs, volume purchased, early payment and distribution to stores. The most favourable trading terms are typically given to larger customers, particularly the MSCs.

The net price paid by the retailer will also reflect further funding by the supplier to support promotional activity. This could involve the sale of the product to consumers at discount prices, product placement in gondolas at the end of aisles or advertising in supermarket catalogues.

Supply arrangements for private label products differ to those for proprietary branded products. Generally, the retailer will specify the required product and estimated sales volumes, and manufacturers will tender for supply of the product. In the case of some premium private label products, supply arrangements will be set through bilateral negotiations between the retailer and a supplier that the retailer considers will be able to deliver the premium product required, rather than through an open tender process.

Contracts for private label supply typically last one to two years, with an option to extend if parties are satisfied.

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116 ABARE, *Australian commodities*, March 2008, p. 33.

117 For an example of public comments, see comments by Bakers Delight, ACCC public hearing transcript, Melbourne, 30 May 2008, p. 27.

118 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 6.

119 Arnott's Biscuits, submission no. 53, p. 2.

Relationship with retailers

As with other grocery items, the final price and other terms on which biscuits are supplied (after allowing for rebates and discounts) are affected by the relative bargaining power of the supplier and retailer. As discussed in chapter 14, key determinants of the relative bargaining power of the parties are the degree to which each party depends on the other.

For the wholesale supply of biscuits, the balance of bargaining power varies considerably depending on the manufacturer and retailer concerned.

As discussed elsewhere in this report, MSCs wield large buying power because they account for such a high proportion of retail sales of groceries in Australia. In this respect, the proportion of biscuits sold through supermarkets is significantly higher than for many other common grocery items because biscuits are not generally sold in specialty outlets in the manner of other grocery items such as bread, meat, seafood, fruit and vegetables. However, some limited sales of biscuits do occur through convenience stores and other retail outlets.

However, a number of factors assist biscuit manufacturers in their negotiations with retailers. Arnott's is a very important supplier from the retailers' point of view, accounting for 57 per cent of supermarket sales of biscuits.[120] Enhancing Arnott's position is the strength its brands names have built up over time. Most notably, the Tim Tam product was identified in a 2006 study as Australia's third most popular brand across all products[121], which means that Arnott's is likely to have significant countervailing power in negotiations with the MSCs.

The next two largest biscuit manufacturers in Australia, Paradise Foods and Kraft/Nabisco, each supply around 6 per cent of biscuits sold in Australia.[122] Given the volume of the MSCs biscuits sales generated by their products, these manufacturers are likely to have considerably less bargaining power in negotiations with MSCs. However, because both companies sell some products with strong brand recognition that are likely to be valued by consumers, they would have a degree of countervailing bargaining power in negotiations.

The strength of biscuit brand names may also explain why private label products are less prevalent in the biscuit category than for some other standard grocery items.

A strong private label presence in a grocery category can affect the relative bargaining power of suppliers and retailers by making the retailer less reliant on branded products. However, private label products account for just over 10 per cent of supermarket sales of biscuits, compared with half or more of sales of sugar, eggs, milk, butter and bread.[123] The ACCC survey of grocery consumers found that 42 per cent of respondents always chose snack foods on the basis of brand.[124] In terms of how important brand name is when choosing a product, snack foods rated second only to soft drinks.

Although private label sales do not currently account for a high proportion of biscuit sales, there has been a major drive to introduce and expand the Woolworths Select range of biscuits. Biscuit manufacturers confidentially said that this has affected sales of their lesser known brand names but that sales of biscuits with strong brand recognition have been largely unaffected.

120 Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2008*, Retail Media, Sydney, 2008, p. 63.

121 George Patterson Y&R, 'Brand asset valuator', 2006.

122 Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2008*, Retail Media, Sydney, 2008, p. 63.

123 Coles, submission no. 157, attachment A, April 2008.

124 ACCC, survey of grocery consumers, April 2008.

Trends in wholesale prices

The ACCC collected confidential data on the wholesale prices of a number of specific biscuit products. The biscuit category has many varieties and many products experienced fluctuations in wholesale prices over time (e.g. because of promotional activity).

Because of these fluctuations, it was hard to determine clear trends in wholesale prices, particularly in respect of proprietary branded biscuits. While there were some changes in wholesale prices over the last few years for the selected products, these changes were not substantial and were not consistent between biscuit products and retailers.

Wholesale prices for private label products were more stable and did not exhibit any discernable upward or downward trend over the last few years.

Arnott's submitted that its direct production costs have increased at a rate faster than its wholesale prices over the last three financial years.[125] One biscuit manufacturer also advised the ACCC confidentially that it had not passed on all its cost increases in its most recent price review.

The pressure on biscuit manufacturers not to pass on increased production costs is likely to be partly caused by strong competition between manufacturers and a desire to see their brands remain price-competitive on supermarket shelves. The MSCs do not appear to constrain biscuit producers from passing on cost increases, possibly because the use of list prices means supermarkets can be satisfied that a change in the wholesale price will apply to all retailers. This is different for private label products, where supermarkets place considerable pressure on their suppliers to justify any price increase.

12.7.2 Retail supply of biscuits

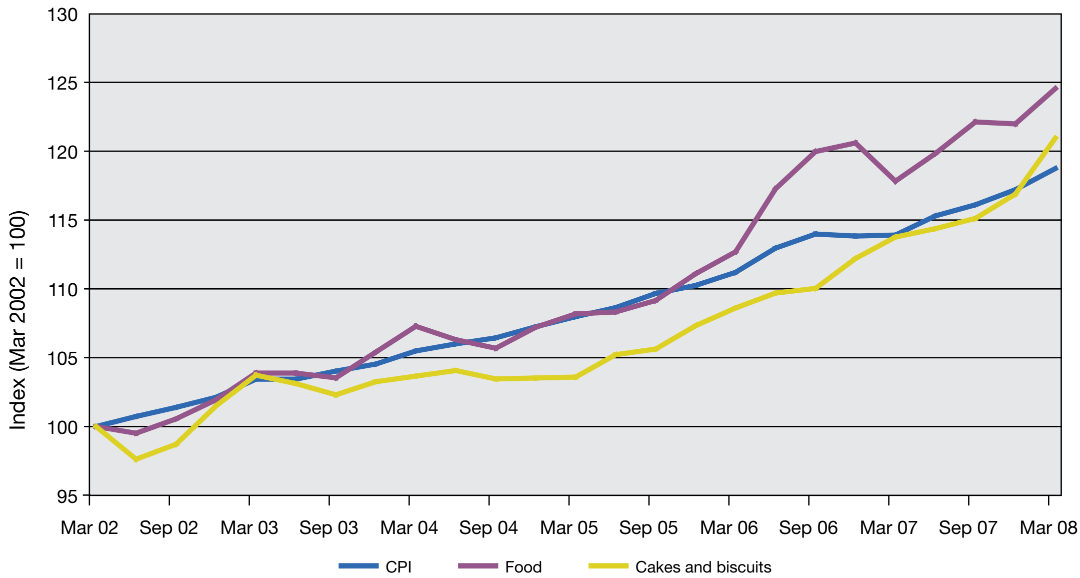
Trends in retail prices

The ABS reports on a subcategory of cakes and biscuits as part of its work on consumer prices. Chart 12.14 shows that nominal prices for cakes and biscuits, as measured by the ABS, increased at a moderate rate of 4 per cent over the three years to March 2005.[126] This was less than half the rate of increase in the food price index and the CPI.

125 Arnott's Biscuits, submission no. 53, p. 3.

126 ABS, *Consumer price index*, catalogue no. 6401.0, March 2008.

Chart 12.14 ABS CPI comparisons—all product groups, food products, and cakes and biscuits



Source: ABS, Consumer price index, catalogue. no. 6401.0, March 2008

Since March 2005 prices for cakes and biscuits have risen by 17 per cent. While this was not much more than the rise in food prices generally (15 per cent), it was much higher than the rate of increase in CPI (10 per cent).

The movement in the prices of cakes and biscuits reported by the ABS is largely consistent with evidence given by suppliers in relation to changes in their input costs. The strong increase in the prices of cakes and biscuits from March 2005 is also seen in the prices of bread, another flour-based product.

As discussed earlier, the overwhelming majority of retail biscuit sales are by supermarkets. This means there is less retail competition in biscuits than for other products, where specialty stores such as bakeries and fruit and vegetable stores promote greater price competition between retailers.

12.7.3 Conclusion

Retail prices for biscuits and cakes increased by a moderate amount in the three years to March 2005, but since then they have increased at a rate slightly more than food prices generally and much higher than the CPI.

Biscuit producers receive approximately 70 to 80 per cent of the retail price of biscuits. Suppliers have advised the ACCC that the cost of many inputs to production have been increasing significantly, in particular ingredients such as flour, butter, shortening and palm oil.

The balance of bargaining power in the relationship between biscuit supplier and retailer can vary greatly depending on the manufacturer and retailer concerned. Supermarkets account for a higher share of biscuit sales than for other grocery items, which places the MSCs in a strong position when negotiating with suppliers. However, a biscuit manufacturer with strong brand names could have a degree of countervailing bargaining power. In particular, Arnott's dominant share of biscuit sales and strong brand names such as Tim Tam are likely to provide it with significant countervailing power in negotiations with the MSCs.

Overall, the ACCC believes that biscuit manufacturers are generally not significantly constrained by the MSCs in their ability to pass on increases in production costs. However, strong competition between biscuit manufacturers and a desire to see their brands remain competitively priced on supermarket shelves appears to constrain price rises to some extent.

12.8 Beef

Key points

- The supply chain for beef is long and complex with the farm gate price of livestock only one of numerous inputs into the eventual cost of a cut of beef. As such, direct comparisons between farm gate and retail prices are difficult and not necessarily instructive.
- Prices at the farm gate and wholesale levels are strongly influenced by international prices. The primary determinants of farm gate prices appear to be international prices and domestic supply and demand.
- The largest domestic purchasers of beef, Coles and Woolworths, each purchase around 6 per cent of domestic production.
- Retail beef prices have risen at roughly the same rate as CPI over the last six years.
- Movements in retail prices are correlated with wholesale prices.
- Gross margins for meat are one of the lowest across the MSC's product categories.
- Given the complexity of the supply chain it is not possible to rule out that there may be some competition problems in specific geographic regions or in specific sale yards. However, given low margins at the retail level and export alternatives the ACCC is satisfied that the supply chain is for the most part competitive and that any competition problems are not occurring at the retail level.

The supply chain for red meat from farm gate to consumers is long and complex. There are a variety of different supply arrangements making it difficult to directly compare farm gate and retail prices. Comparison is further complicated by the variety of cuts that can be produced from a single carcase, with each cut as a proportion of the carcase in terms of volume and value varying depending on the cut set extrapolated.

Accordingly, it is not possible to follow a particular cut of meat from the farm gate through to the supermarket shelf with any precision. As such, the ACCC has taken a whole-of-carcase approach in attempting to track costs and margins through the beef supply chain.

12.8.1 ACCC red meat report

The ACCC red meat report to the Minister for Agriculture, Fisheries and Forestry, *Examination of the prices paid to farmers for livestock and the prices paid by consumers for red meat*, was publicly released in February 2007.[127]

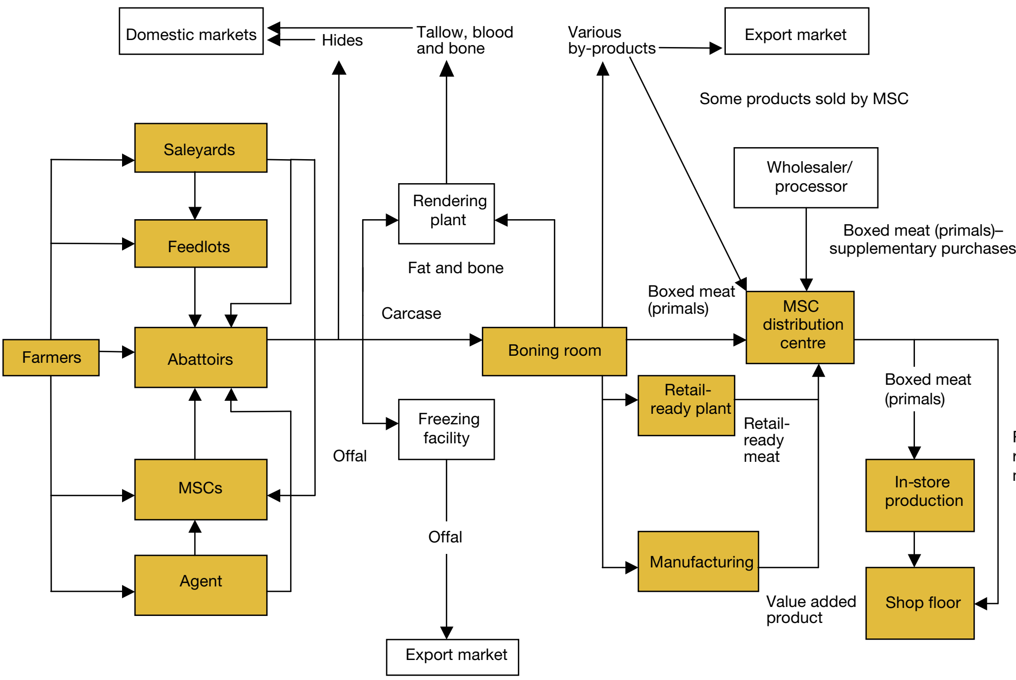
127 ACCC, *Examination of the prices paid to farmers for livestock and the prices paid by Australian consumers for red meat*, February 2007. Copies of this report are available from www.accc.gov.au.

This report did not consider costs and prices at all levels of the supply chain. Rather, the focus of the report was prices paid to farmers for livestock—specifically cattle and sheep—and retailer prices of beef/veal and mutton/lamb.

This case study considers all stages in the supply chain for beef from the farm gate to the checkout. However, much of the analysis in the red meat report is relevant to consideration of the supply chain for beef and has been drawn on in this case study.

12.8.2 Background

Chart 12.15 Beef supply chain



Highlighted areas indicate the main steps in the supply of saleable beef products from the farm gate level through to the supermarket shelf.

There are a number of stages in the supply chain of beef from farm gate to consumer.

The main levels of the beef supply chains are:

- cattle farming
- feedlots where livestock are fed a particular mix of feed for a period to reach quality specifications
- processors and/or wholesalers who slaughter and prepare the beef for retail sale
- retailer sale.

Markets for cattle

There are three basic markets for cattle: store, domestic and export.[128] Store cattle are not suitable for immediate slaughter. Rather they are purchased for 'backgrounders'[129], by feedlots for finishing to specification and for live export. Store cattle are also not generally suitable for the domestic market.

Cattle sold in the domestic market are generally younger and lighter than those specified for export, although there can be some overlap depending upon the country the meat is likely to be exported to.

Purchasers of cattle at the farm gate level are primarily lot feeders, processors and the MSCs.

At the wholesale level (post processing) there are four main categories of domestic purchasers: the food service industry, supermarkets, food manufacturers, and institutions, such as hospitals.

The MSCs purchase beef at both the farm gate and wholesale and/or processor level.

Around 65 per cent of Australian produced beef is exported.[130] Meat and Livestock Australia (MLA) estimated that of the 35 per cent of beef sold domestically in 2007, approximately 5 per cent was directed to the processing sector, 27 per cent to the food service industry and 68 per cent went to the retail sector.[131] Of the 68 per cent of beef sold at the retail level the MLA estimated that the MSCs accounted for approximately 52 per cent and butchers, 30 per cent; with the remaining 18 per cent being accounted for by other supermarkets, delicatessens and other parties.[132] This places the share of total Australian beef production sold through the MSCs at approximately 12 per cent.

While the MSCs purchase a relatively small proportion of Australia's total beef production, it was submitted that they are the biggest domestic purchasers of beef.

The MSCs supply arrangements

This case study examines each step in the supply chain for beef from farmer through to retailer.

Both Coles and Woolworths have vertically integrated supply and service agreements throughout the supply chain with farmers, feedlots and processors.[133] Before considering in detail each stage of the supply chain for beef, Coles and Woolworths vertically integrated supply arrangements are briefly summarised here.

In submissions to the ACCC inquiry into red meat prices, the MSCs stated that their service and supply arrangements involve setting prices based on prevailing costs of production, including the cost of grain feed and a profit margin. These prices are negotiated in advance and set for various periods, providing supermarkets and producers with a degree of price certainty.[134]

Woolworths purchases finished cattle from both feedlots and farms (supplementary cattle).[135] Woolworths submitted that it does not purchase cattle from saleyards.[136]

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128 R Cheffins, *Nutritional and managerial opportunities for meeting beef markets*, Queensland Department of Primary Industries, 1996, p. 5.

129 A backgrounder is a cattle producer who produces young cattle ready for lot feeding.

130 ABARE, *Australian beef industry: financial performance to 2005–06*, Canberra, 2006, p.1

131 Meat and Livestock Australia, information provided to the ACCC, 16 July 2008, based on data provided by BIShrapnel/Roy Morgan.

132 Meat and Livestock Australia, information provided to the ACCC, 16 July 2008 based on data provided by BIShrapnel/Roy Morgan.

133 ACCC, *Examination of the prices paid to farmers for livestock and the prices paid by Australian consumers for red meat*, February 2007, p. 9.

134 ACCC, ibid., pp. 9, 20.

135 Woolworths, response to ACCC informal information request, cited with the consent of Woolworths.

136 Woolworths, ibid.

In line with industry practice, suppliers pay transportation costs to abattoirs and Woolworths pay transportation costs from that point.[137]

Woolworths also produces some of its own value-added products such as rissoles and sausages.[138]

Coles submitted that to overcome supply constraints in the early 1990s caused primarily by the attractiveness of returns in overseas markets to meat processors, Coles established a group of dedicated livestock producers to provide a reliable supply of quality meat. Colestock livestock producers grow and deliver cattle and lambs to Coles' specifications.[139] Coles submitted it negotiates prices in advance with Colestock suppliers taking into consideration key drivers such as feed prices, store cattle costs (the costs producers pay prior to entering feedlots) and other market forces. Coles submitted the desired outcome of these negotiations is to achieve a fair price for both parties that is relative and competitive with the market.[140]

Coles further submitted that livestock costs associated with its 'Alliance' processors are based on daily commodity prices, dictated by market conditions. The daily prices may be aggregated over a period of time for consideration during negotiations.[141]

Coles sources its beef through both the integrated supply chain and the open market in the form of boxed beef.[142]

12.8.3 Cattle farming

There are approximately 75 000 properties in Australia on which beef cattle are bred, many of which are small scale family owned farms.[143]

These farms produce around 4 per cent of the world's beef supply and Australia is the second largest beef exporter in the world, behind Brazil. Australia produces over 2 million tonnes of beef and veal annually.[144]

The Western Australian Red Meat Industry submitted that the Australian livestock market is not a single homogenous market.[145] As a very broad generalisation, beef production systems can be split in to northern Australian and southern Australian systems. Production of beef in northern Australia is characterised by large property and herd sizes. Moreover cattle produced in northern Australia tend to be from *Bos Indicus* breeds[146] better suited to the warmer conditions in the north. Such cattle are also better suited to export market specifications (including the live export market) because they are heavier than cattle produced in southern Australia.

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137 Woolworths, ibid.; Woolworths response to s. 95ZK notice cited with the consent of Woolworths.

138 Woolworths, ibid., cited with the consent of Woolworths.

139 Coles, response to ACCC informal information request, cited with the consent of Coles.

140 Coles, response to ACCC informal information request, cited with the consent of Coles.

141 Coles, response to ACCC informal information request, cited with the consent of Coles.

142 Coles, response to ACCC informal information request, cited with the consent of Coles.

143 ABARE, *Australian beef industry: financial performance to 2005–06*, Canberra, October 2006, p. 4.

144 ABARE, ibid., p. 1.

145 Western Australian Red Meat Industry, submission no. 82, p. 4.

146 *Bos indicus* are breeds of cattle referred to as tropical or humped breeds such as Brahman, Sahiwal and other Zebu breeds. Source: www.mla.com.au/HeaderAndFooter/Glossary.htm.

Beef production in southern Australia can be characterised by smaller property and herd sizes to those in the north of the country. Cattle is usually of a *Bos taurus*[147] breed, which is better suited to cooler southern conditions and also produces lighter weight cattle more suited to domestic market specifications. That said, industry sources submitted there is some overlap of specifications and different breeds of beef are substitutable for both the domestic and export markets.[148]

Key inputs into cattle farming

In addition to the farming property and (grass-fed) cattle, the key inputs at the farm level are fertilisers and chemical costs, labour, fuel prices and interest rates. Combined (excluding cattle) these factors comprise over 56 per cent of total cash farm costs.[149] Submissions from a range of parties[150] indicate that fertiliser and chemical costs have more than doubled over the past 12 months, which has significantly increased the cost of producing cattle. The ACCC heard that producers are not adequately covering their costs of production and are therefore exiting the industry.[151] Parties also submitted that producers have been known to forgo making a profit to maintain their preferred supplier status but acknowledged that this could not be sustained long term.[152] Costs associated with grain-fed beef are considered below in the discussion of feedlots.

Sale methods

There are a number of channels through which producers can sell cattle including paddock sales, over the hooks (OTH), auction sales and over the scales. Auction sales (generally at saleyards) and OTH are the most common methods for selling cattle,[153] with auction sales at 44 per cent and OTH sales at 40 per cent in 2003–04. The shift over the past decade from auction systems to more direct selling methods, such as OTH, is to some extent driven by changes in the distribution of beef cattle, herd sizes and markets targeted.[154]

Victoria, South Australia and New South Wales, being states with a higher proportion of relatively small herds, have the highest proportion of auction sales. Other factors accounting for the comparatively higher level of auction sales in these states are likely to be the closer proximity to saleyards and the fact that abattoirs in southern states predominantly service domestic markets.[155]

Stock sold at auction is either on a dollars per head basis, or if weighed, on a cents per kilogram live-weight basis. Auction sales involve additional costs and stock handling which may mask the quality–price relationship.[156] Paddock sales are more likely to be used by producers with large herd sizes or for producer-to-producer sales of store or breeding stock.

As suggested by the name, cattle sold OTH are weighed and a price is calculated following slaughter and trimming. Processors and MSCs primarily purchase stock OTH with the payment method to

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147 *Bos taurus* are temperate, British or European breeds of cattle such as Angus, Poll Hereford, Charolais and Limousin. Source: www.mla.com.au/HeaderAndFooter/Glossary.htm.

148 Cattle specification information sourced from the Queensland Department of Primary Industries and Fisheries.

149 NFF, submission no. 137, p. 11; ABARE, *Australian Commodities—December quarter,* 07.04, December 2007, www.abareconomics.com/interactive/ac_dec07/pdf/ac_dec07.pdf.

150 NFF, submission no. 137, pp. 10–11; NSW Farmers Association, submission no. 155; WA Farmers Federation, submission no. 106; AgForce Grain, submission no. 111, to cite a few.

151 ACCC, public hearing transcript, Perth, 22 April 2008, p. 74; ACCC, public hearing transcript, Bunbury, 23 April 2008, pp. 47, 53, 55.

152 ACCC public hearing transcript, Bunbury, 23 April 2008, pp. 9, 51–52.

153 ABARE, *Australian beef industry—production and sale of beef cattle,* December 2004, p. 7.

154 ABARE, ibid.

155 ABARE, ibid., p. 8.

156 ABARE, ibid., p. 7.

producers based on a hot standard carcase weight (HSCW)[157] using a pricing grid that sets out various price points depending on the weight, grade and quality of the meat and the value of the hide.

Processors and/or the MSCs retain the co-products from these animals while producers are paid for the gutted and trimmed carcase and generally receive a rebate or credit for their hides.

Co-products account for approximately 11 per cent of the value of a slaughtered animal.[158] MLA estimated the value of co-products is $1.7 billion per annum.[159] Processors and retailers sell co-products to both domestic and export markets, both retail and non-retail. DAFF noted in its report, *Price determination in the Australian Food Industry,* a research report prepared by Whitehall and Associates [160],that on the basis of its model the extracted value of co-products makes up more than 20 per cent of gross returns.

Where stock is purchased by an MSC, the MSC will usually have a service agreement with a processor. Depending on the arrangements the MSC has with processors with regard to excess meat and co-products, this may offset some or all of the MSC's processing costs.

Key determinants of farm gate prices

The NSW Farmers Association submitted that farm gate prices are determined by supply and demand and farmers are price takers.[161] Previous reports have also noted that supply and demand are the predominant determinants of farm gate prices. DAFF's report, noted that farm gate cattle prices are influenced by:

- the strength of international demand
- the demand for store and breeding cattle
- the level of available supply
- prevailing export prices.[162]

In particular, with 65 per cent of all production being exported, world prices significantly influence farm gate returns to Australian cattle farmers.

Concerns were raised during the course of the inquiry that the buyer power of the MSCs was acting to suppress farm gate prices.[163] In particular, the Red Meat Action Group suggested that while international prices are important the buyer power of the MSCs was an equally important influence on farm gate prices. Other sources accepted that the MSCs were an influence on the market but suggested that the MSCs' influence is limited to the particular types of cattle they purchase.[164]

Specifically, it was argued confidentially that as the MSCs are known for buying quality stock, other purchasers in the market set their farm gate price below or around the price set by MSCs, allowing the MSCs to effectively create a price ceiling. The mechanism by which this price setting was done was never clearly articulated.

157 HSCW is where the carcase is weighed following slaughter and trimming but before it is cooled or chilled.

158 See www.mla.com.au/TopicHierarchy/Informationcentre/CoProducts/Default.htm, sourced 9 July 2008.

159 See www.mla.com.au/TopicHierarchy/Informationcentre/CoProducts/Default.htm, sourced 9 July 2008.

160 S Spencer, *Price determination in the Australian food industry, a report,* Department of Agriculture, Fisheries and Forestry, Canberra, p. 42.

161 NSW Farmers Association, submission no. 155, p. 15.

162 S Spencer, *Price determination in the Australian food industry, a report,* Department of Agriculture, Fisheries and Forestry, Canberra, 2004, p. 39.

163 ACCC, public hearing transcript, Bunbury, 23 April 2008, p. 47.

164 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 24.

In submissions to the ACCC red meat inquiry, Coles and Woolworths both said that they buy a relatively small share of the total beef produced in Australia. A number of other parties also submitted to the red meat inquiry that no one purchaser was able to distort the market because producers that were dissatisfied with prices offered by one purchaser could alter the specifications of their stock to target other purchasers or export markets.

The ACCC considers that given that each of the MSCs only purchase around 6 per cent of Australian beef production it is unlikely that they would be able to exert sufficient pressure in the market to suppress farm gate prices.

While no one buyer purchases a significant amount of the total volume of cattle at the farm gate, it was submitted by various parties that producers must sell their cattle when market specifications are reached and therefore their options in terms of potential buyers are more limited than they may otherwise appear.[165] In particular, the Australian Beef Association (ABA) submitted that producers only have a small window of opportunity (generally several weeks) in which to shop around before their cattle goes 'off specification'.[166]

The ABA submitted that a farmer must determine which market it wants to sell its cattle to almost at the time that the cattle production is commenced.[167] This includes focusing on particular genetics which are likely to be better for certain markets, and targeting the stage at which cattle need to be finished. The ABA submitted that there is little flexibility in who cattle producers can sell to because they must prepare the cattle with a particular buyer in mind (for example, export, domestic, supermarket etc.).[168] The ABA submitted that efficient low cost beef production requires producers to target specific market segments and each market segment has defined carcase parameters.[169] The ABA further submitted it takes a cow-calf operator a minimum of three to five years to produce a line of cattle for a specific market.[170]

Similarly, the Western Australian Red Meat Industry also submitted producers are unable to alter their specifications to target alternative markets.[171]

Others submitted, both previously for the ACCC red meat report and in the context of this inquiry, that there is sufficient competition between the domestic and export markets to allow domestic producers to switch supply to export markets if they are unhappy with the price offered in the domestic market.

Coles' submission[172] and other confidential submissions to the inquiry, argued that producers have many options available during the lifecycle of the herd to determine how and when to market their livestock. Further, they claim it is possible for producers to change their decision as to which market to sell to in a relatively short period.

165 ACCC, public hearing transcript, Canberra, 30 April 2008, pp. 20–21; ABA, submission no. 221; Western Australian Red Meat Industry, submission no. 82, p. 15.

166 ABA, submission no. 221, pp. 4, 6.

167 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 108.

168 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 108.

169 ABA, submission no. 221, p. 2.

170 ibid, pp. 2, 7.

171 Western Australian Red Meat Industry, submission no. 82, p. 15.

172 Coles, submission no. 225, 3 June 2008, p. 32.

While it appears possible for a producer to switch supply from the domestic market to the export market, if unable to achieve a reasonable rate of return, the circumstances in which it would be viable for a producer to do so is less clear. This may depend on a number of factors, including the size of the producer, size of the herd, and location—that is, southern versus northern states.

Further, any potential increase in the price that might be obtained from shopping around may be offset by other costs, such as penalties for missing specifications, transport costs, additional feeding costs and so on. Consequently, it appears to be reasonably common for a beef producer in a falling market to find themselves having incurred costs in raising cattle, which they may not be able to recover, when bringing the herd to market. The producer cannot pursue alternative options without further expenditure, nor are they in a position to directly influence or negotiate returns except within the parameters of the current market price.

The ACCC view is that this outcome is one of the inherent risks in raising cattle for a specific market without any forward price protection. This transactional vulnerability of an individual producer should not, however, be mistaken for a broader market failure, or an ability on the part of another market participant to set prices by reference to factors other than supply and demand.

To avoid this, many producers enter into forward contracts with MSCs to hedge against market fluctuations when cattle are ready for sale.

This practise suggests that MSCs do not take advantage of short-term constraints on a producer's ability to switch supply options in order to suppress farm gate prices. Their conduct appears to be directed at providing additional price certainty to maintain reliability of supply. Prices offered by the MSCs, however, remain within the constraints of market conditions.

Movements in farm gate prices

The National Farmers Federation (NFF) submitted that farm gate prices have either remained stagnant or only increased by a small percentage while farm costs such as chemicals and fertiliser have doubled in the past 12 months.[173] The NSW Farmers Association also submitted the cost of production has increased by at least 35 per cent over the past decade, while the price paid to farmers has not significantly changed.[174]

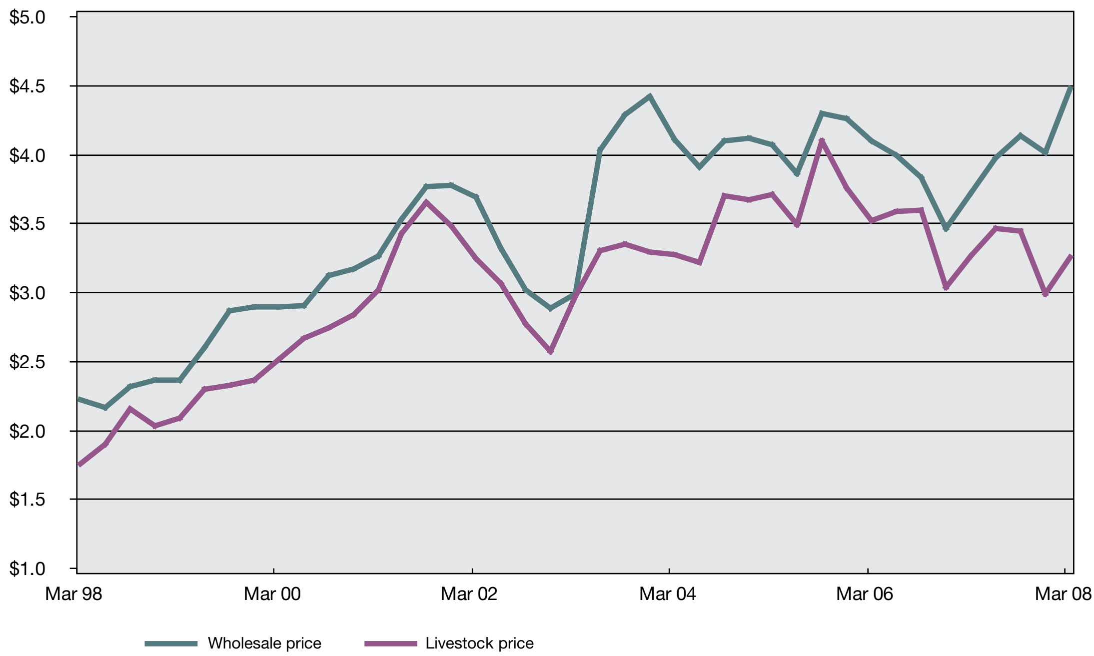
To investigate this claim that farm gate prices have been stagnant the ACCC looked at farm gate (livestock price) and wholesale price data collected by the MLA.[175]

173 NFF, submission no.137;p. 10, ACCC, public hearing transcript, Canberra, 30 April 2008, p. 13.

174 NSW Farmers Association, submission no. 155, p. 15.

175 Data collected by the National Livestock Reporting System.

Chart 12.16 Beef livestock and wholesale price movements



Source: MLA[176]

Chart 12.16 illustrates the average livestock prices for domestic steers[177] and average wholesale prices for beef. The ACCC has used domestic steer prices as the closest proxy for the type of cattle purchased by MSCs. Although these prices do not reflect the prices paid by the MSCs, as they primarily purchase grain fed beef from feedlots, confidential data provided by the MSCs indicates the margin between the two prices is relatively constant.

The chart shows that the farm gate price has not been stagnant. The price is extremely volatile but has moved upwards in nominal terms by 85 per cent between March 1998 and March 2008. Using the CPI as a deflator to account for rising costs, the increase in real terms is slightly more than 35 per cent over the same period.

Looking forward, ABARE forecasts the Australian weighted average saleyard price of cattle will increase by 3 per cent in 2008–09 to 294 cents per kilogram (dressed weight) because of a decrease in cattle turned off for slaughter as producers rebuild their herd numbers.[178] ABARE's projection is based on an anticipated increase in domestic production coupled with an anticipated increase in competition in key export markets.[179]

While farm gate prices have not produced significantly improved returns to primary producers, there have been upward movements in the market price.

176 Livestock price = saleyard cattle prices, national weighted average domestic steer 180–220 cwt (C3). All c/kg cwt (Source :NLRS); wholesale price = young cattle 160–210kg dwt (C3), c/kg (Source: NLRS).

177 Domestic steer prices are considered to be the closest proxy for cattle purchased by the MSCs even though this category may include cattle that are not suitable for processing.

178 ABARE, *Australian Commodities*, June quarter, vol. 15, no. 2, 2008, p. 361.

179 ABARE, *Australian Commodities,* March quarter, vol. 15, no. 1, 2008.

12.8.4 Feedlots

The vast majority[180] of beef sold in Australia is finished on grain in feedlots—that is, the livestock are fed a particular mix of feed for a specified period to reach a specified quality.

Cattle are sent to feedlots at around 12 to 14 months of age. Cattle for the domestic market are generally fed between 60 to 70 days, whereas certain cattle destined for the Japanese market may be fed for up to 300 days (wagyu is approximately 450 days).

Grain costs were identified as the primary input in the feedlot sector. As noted in a number of submissions[181] and chapter 2, grain prices have more than doubled in the last two years. This has significantly increased the cost of finishing cattle in feedlots.

Details of negotiations with processors and MSCs

Cattle sourced from feedlots are generally supplied to MSCs on a forward contract basis taking into account the cost of the animal, feed costs and likely returns which gives the feedlotter certainty and sufficient information to decide whether to take on finishing of an animal.

In its red meat report the ACCC noted industry views that the pricing structure within the feedlot industry is very transparent. If the feedlots are not satisfied with the price offered to them by the supermarkets, they will refuse to supply the supermarkets and target other markets instead.

This view is supported by the Australian Lot Feeders Association (ALFA) which, in preparing its submission to the red meat inquiry, undertook a survey of lot feeders. In respect of this survey, ALFA submitted:

> In each response from the feedlots one simple comment was reiterated; that the Australia cattle and beef markets are so highly competitive and complex that the potential for any single business within the market to dictate prices is considered negligible. The high level of global competition and the ability for processors, feedlots or extensive producers to move production from domestic to export markets was noted. Some feedlots described the cattle industry as a near perfect market; in that there is a high level of price disclosure, large numbers of buyers and sellers, relative ease of entry and (to a lesser degree) a uniformity of product. At a retail consumer level the ability to exchange beef purchasing for other competing proteins was also noted.[182]

12.8.5 Processors

The meat processing industry is a low margin, high volume business, with profitability and high utilisation closely related.

There are between 250 and 300 meat processors in Australia, with an increasing number becoming vertically integrated, producing cattle and owning feedlot facilities, as well as performing processing and wholesaling.

A survey conducted by MLA found that in 2006 the top 25 processors in Australia accounted for 77 per cent of total red meat production and the majority of these processors operated single species facilities, primarily beef.[183]

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180 Australian Lot Feeders Association, www.feedlots.com.au/index.php?option=com_content&view=article&id=73&Itemid=95, 28 July 2008.

181 WA Farmers Federation, submission no. 106, p. 5.

182 ALFA, submission to ACCC red meat inquiry, January 2007.

183 Meat and Livestock Australia, *Top 25 red meat processors 2006,* September 2007.

In 2007 Australia's four largest processors were forecast to account for just below 47 per cent of total meat processing.[184] The ACC, the tenth ranked processor in the survey, supplies Coles. Tasman Group Services Pty Ltd (ranked fourth), Cargill Beef (fifth) and T&R Pastoral (sixth) all provide services to Woolworths, as well as to other customers.

Processors supply a number of different products and services to a range of customers, including processing and supply of primal cuts (boxed/case-ready meat), and service kills for a fee.

Where processors provide service kills, they will also usually provide basic processing such as boning and cutting into primals, which MSCs or other customers will further process in-store.

Prices for products and services are primarily negotiated on prevailing market conditions. The main processing stages are:

- slaughter
- hide removal
- removal of internal organs
- trimming
- weighing
- chilling
- boning
- further processing (in some instances)
- supply of case-ready meat.

Industry sources indicated the key cost for processors is labour. A significant issue for processors in this regard is that throughput of livestock is often variable, making it cost prohibitive to maintain a full-time workforce sufficient to meet a plant's total processing capacity. Accordingly, processors are somewhat reliant on casual labour.

While processors rely on casual labour to some extent, confidential evidence provided to the inquiry suggested they will buy stock at a loss if necessary to keep the plant operating and to retain their labour force.

Confidential information provided to the inquiry indicated that increased costs of production are being offset to some extent by increased efficiencies in slaughtering and processing the cattle rather than being passed on further up the supply chain.

Low margins in processing, the need to maintain volumes of throughput and evidence suggesting that processors have offset recent increases in costs of production with efficiency gains rather than passing on cost increases through the supply chain, suggests that competition between processors is strong.

Processors appear to primarily purchase cattle OTH, which means that they pay for a slaughtered and trimmed animal, on a cents per kilogram basis based on a pricing grid having regard to current market prices. It does not appear that individual negotiations occur between farmers and processors.

Some processors also supply boxed/case-ready meat to the MSCs on a regular and/or contractual and/or ad hoc basis and charge according to international market prices.[185]

184 JBS Swift & Co/Australia Meat Holdings Pty Ltd, Teys Bros (Holdings) Pty Ltd, Nippon Meat Packers Australia Pty Limited and Tasman Group Services Pty Ltd.

185 ACCC, public hearing transcript, Melbourne, 12 May 2008, pp. 21, 23.

Movements in wholesale price

As can be seen from chart 12.16, there is a close correlation between the movements in wholesale prices and livestock prices.

The wholesale price movements are consistent with claims that processors will buy stock at a loss to ensure throughput at the abattoir and retain labour.[186]

The ACCC was provided with average prices of case-ready meat supplied to wholesalers and the MSCs. The data indicates that prices may vary significantly depending on the particular cut of meat supplied. However, because of insufficient data, the ACCC is unable to draw any meaningful conclusions other than it appears case-ready meat is supplied on the basis of international prices.

12.8.6 Retail sale of beef

In submissions to the inquiry, a number of participants raised concerns that the gap between farm gate and retail prices for beef has increased significantly over recent times. Given the amount of processing involved in preparing beef for retail sale, such a trend is not necessarily indicative of a competition problem, but the inquiry gathered data to determine whether this was in fact the case.

In the last two years the Beef and Veal CPI sub-group index published by the ABS has broadly followed trends in the wholesale and retail market.[187] During 2006–07 the index showed an overall fall in the retail price, reflecting falls at the wholesale and farm gate levels. Between June 2007 and March 2008 the Beef and Veal CPI sub-group index showed an increase, as did prices at the farm gate and wholesale levels.

The ACCC then examined whether this trend of increases in the farm gate and wholesale prices was reflected over a longer timeframe. To compare retail, farm gate and wholesale price movements over time the ACCC used the beef and veal CPI subgroup index (which tracks relative movements in retail prices) and constructed a farm gate price index based on the MLA livestock price index which tracks farm gate price movements. Since 1999 increases in farm gate prices have, in percentage terms exceeded retail prices.

Retail price movements

A more reliable method of comparing retail and wholesale price movements is to index the beef and veal CPI (which tracks relative movements in retail prices) and construct a farm gate price index based on the MLA livestock price index which tracks farm gate price movements. Since 1999 increases in farm gate prices have, in percentage terms exceeded retail prices.

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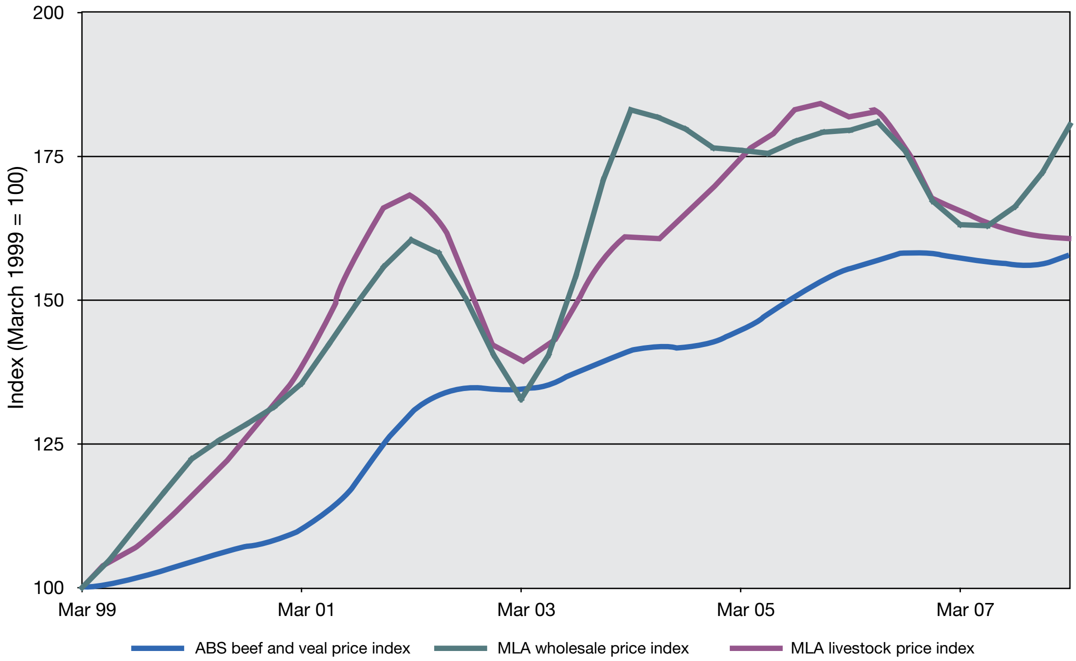
186 The March 2003 result is the month most consistent with such a conclusion.

187 ABS cat. no. 6401.0, *Consumer Price Index, Australia, June 2008*, Canberra, 23 July 2008.

Chart 12.17 Farm gate and wholesale price movements

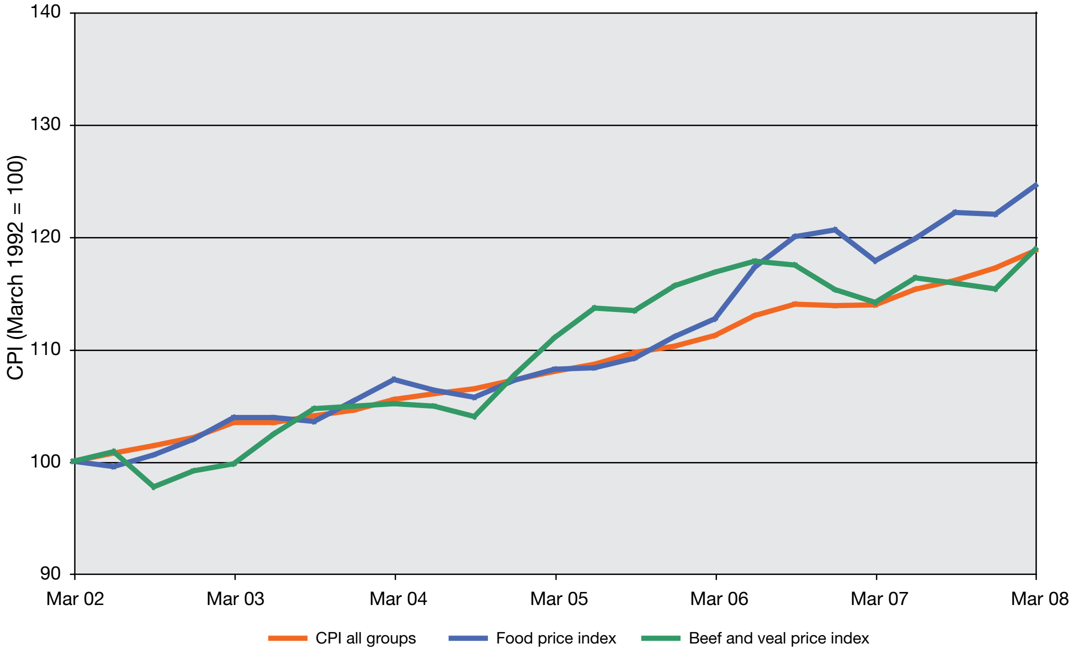


Source: MLA, NLRS

The relationship between prices at the farm gate and wholesale level is reasonably close but there are regular points of diversion. The farm gate and wholesale prices are, however, not closely tied to, and exhibit much more volatility than, retail prices. Over time though there has been no persistent trend of farm gate pricing reducing as a proportion of the final retail price.

It is also instructive to consider where retail price movements in beef and veal sit relative to the CPI and the food price index.

Chart 12.18 Price indexes



Source: ABS, ABARE

Chart 12.18 above shows that the beef and veal CPI sub-group index roughly tracked the food price index until late 2004, although more recently the food price index has increased at a greater rate. Between the end of March 2005, beef prices increased at a higher rate before the food price index took over. Beef prices have remained relatively stagnant since that time.

Producers emphasised at hearings that drought is not the cause of increased retail prices as they are continuing to receive the same prices as they did six years ago.[188] The ACCC is satisfied that in relation to beef, drought is not responsible for any price increase. However, there are many other costs in the supply chain that contribute to the relatively modest increases in the retail price of beef. For example, as a large proportion of meat sold in supermarkets is from livestock finished on grain, even where there has been a decrease in the cost of livestock, higher feed costs have offset any decrease. Labour, capital, fuel and other costs have also risen. The increase in the retail price of beef, which has generally been in line with the CPI over the last six years, is modest when compared to the changes in costs that have occurred at the wholesale level.

188 ACCC, public hearing transcript, Perth, 22 April 2008; ACCC, public hearing transcript, Bunbury, 23 April 2008; Grahame Dunne, submission no. 200.

While the ACCC did not obtain the MSCs' gross margins for beef specifically, the MSCs provided information on the gross margins for the sales of particular product categories, including meat. The information indicated that gross margins for meat have decreased slightly over the last five years. More generally, the MSCs earn lower margins on meat than they do on most of the other standard grocery items examined in these case studies.

At the retail level it appears that the MSCs face strong competition from other retailers—and in particular butchers—in selling beef. As noted in chapter 5, 67 per cent of shoppers surveyed in the ACCC's consumer survey made less than half their 10 most recent meat and fish purchasers through a supermarket. It should be noted, however, that these figures do not take account of the quantity of meat and fish purchased in each of these shopping trips.

As noted in chapter 9, ACNielsen ScanTrack data and Roy Morgan survey data indicated that the MSCs' share of fresh meat sales is less than 50 per cent. Specifically for beef, the MLA estimates that around 50 per cent of retail sales are through the MSCs.

The MSCs gross margins for meat are low compared to other standard grocery items examined. Further, the MSCs have more competitors in respect of meat sales compared to many other grocery items. This suggests that retail competition in supplying beef to consumers is strong.

Direct comparisons between farm gate and retail prices

The ACCC received a number of submissions comparing the farm gate price with the retail prices for particular cuts of beef. To make valid comparisons a number of factors should be considered, including the 'yield', or percentage of saleable meat, derived from a carcase, as well as the volume and value of the various cuts.

The ACCC received conflicting submissions indicating that yields from an animal can vary greatly depending on the cuts extracted. Figures ranged between 20 per cent and 70 per cent, while freshlogic submitted that 60 per cent of the total carcase is saleable meat.[189] One industry source indicated that of the 60 per cent to 70 per cent of saleable meat obtained from a carcase, approximately 35 per cent to 40 per cent will be manufacturing meat.

Coles provided a table of an average set of cuts for retail sale derived from a beef carcase, including the percentage of the live weight, saleable kilograms and average retail prices for a particular period. A product set will vary in the type of cuts, volume and value obtained from a carcase.[190]

Two of the highest value cuts, eye fillet and scotch fillet, on average make up 1.3 per cent of the live weight and less than 4 per cent of the total saleable kilograms from a carcase.[191]

Accordingly, caution should be exercised when making comparisons between farm gate and retail prices. In particular, the NFF submitted that the farm gate price of food often represents only a small portion of the end retail price and that, therefore, movements in the farm gate price do not always reflect retail price movements.[192] The ACCC red meat report also noted that there will not necessarily be a direct and immediate relationship between the price of the raw product and the final good.

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189 Freshlogic report, p. 49.

190 Coles response to ACCC informal information request, cited with the consent of Coles.

191 Coles, response to ACCC informal information request, cited with the consent of Coles.

192 National Farmers Federation, submission no. 137, pp. 7, 8.

The 2004 DAFF report estimated the farm gate price as a percentage of retail price of beef at around 20 per cent.[193] Although, as others have also noted, the DAFF report stated that such comparisons are inherently complex and the subject of a large number of assumptions regarding meat quality, market conditions and cost structures.

As noted in the ACCC's red meat report, while there is a relationship between the price paid to farmers for livestock and retail meat prices, there are many factors throughout the supply chain that make drawing simple linear relationships problematic. The assumption that there should be a direct and immediate link ignores the complexity of the supply chain itself and of the supply arrangements within the chain.

Comparisons between Australia and overseas retail prices

During this inquiry the ABA made a number of claims, both to the ACCC and in the media[194], identifying the MSCs as the single biggest contributor to what they consider to be poor farm gate prices and inflated retail prices being paid by consumers, particularly when compared to other countries. The Red Meat Action Group also made some similar claims.[195]

Specific claims include that consumers in Australia are paying double the prices paid by consumers in the United States for the equivalent beef products, despite US farmers receiving more for their cattle at the farm gate. In support of this claim, the ACCC notes the ABA compared the average sirloin beef price in Australia to the price in a number of other countries. The ABA cited the United States Department of Agriculture as the source of the US figures:

- Western Australia $35.95 per kg
- Australia $28 per kg
- United States $13.82 per kg
- Japan $23.94 per kg

The ABA also stated that prices in the United Kingdom and Ireland were $34 per kg and $30.51 per kg respectively, but that producers in those countries receive more for their cattle.

The ACCC notes that the NFF advised caution in making direct comparisons with retail prices in other OECD countries, given the distorted nature of agricultural trade globally as indicated by the average tariffs on agricultural products being more than three times higher than those on non-agricultural goods. The NFF submitted the level of domestic support for agriculture in Australia at 4 per cent of farm income (compared to 33 per cent, 18 per cent and 56 per cent in the European Union, the US and Japan respectively) is among the lowest when compared with OECD standards.[196] This, the NFF argued, demonstrates that Australian agriculture is more exposed to the market than its OECD counterparts and results in significant variation in the market dynamics which underpin agricultural prices in different countries.

DAFF advised[197] that comparisons between Australia and other countries are difficult because of differing production methods (e.g. grass compared with grain-fed), processing plants and efficiencies

193 S Spencer, *Price determination in the Australian food industry, a report,* Department of Agriculture, Fisheries and Forestry, Canberra, 2004, p. 39.

194 ABA, submission nos. 44 and 146; ACCC, public hearing transcript, Canberra, 8 April 2008, p. 98; *Farm Weekly*, 11.6.08; and farmonline, to cite a few.

195 ACCC public hearing transcript, Bunbury, 23 April 2008, p. 56.

196 NFF, submission no. 137, p. 6.

197 DAFF, Livestock Industries Branch, Agricultural Productivity Division, June 2008.

(e.g. relatively small processing plants in Australia compared with some very large integrated plants in the US), selling methods (e.g. livestock saleyard prices that are reported compared with contracts for livestock that are sold direct to works, which are not readily available to the public) and input costs vary (e.g. cheaper feed corn is used in the US).

DAFF noted that the international prices it cited were drawn from a number of data sources which it could not reconcile with the ABA data. Further, DAFF also noted difficulties in how particular cuts were defined—in some circumstances, a US sirloin is the equivalent of an Australian rump—and could not conclude whether the ABA prices reflect like-for-like US and Australian sirloin cuts. All this calls into question the utility of the comparisons.

DAFF also stated that if it is the retail price of an Australian rump[198] steak that is more appropriate for comparative purposes then the average Australian price moves closer to the US sirloin retail price.

DAFF also examined Japanese prices with data provided by the Agriculture and Livestock Industries Corporation (ALIC).[199] DAFF advised it was again unable to reconcile the retail sirloin price identified by the ABA with ALIC's May 2008 figures. DAFF advised the national Japanese average retail price (¥379 per 100 g plus a consumption tax of 5 per cent) for Australian sirloin in March 2008 was calculated to be the equivalent of AUD$39.28.

Accordingly, the ACCC is reluctant to draw any conclusions from the international comparisons submitted to the inquiry.

12.8.7 Conclusion

The supply chain for red meat from farm gate to consumers is long and complex. A variety of different supply arrangements make it difficult to directly compare farm gate and retail prices. Such comparisons are further complicated by the variety of cuts that can be produced from a single carcase, with each cut as a proportion of the carcase in terms of volume and value varying depending on the cut set extrapolated. Further, the farm gate price of livestock is only one of numerous inputs into the eventual cost of a cut of beef. As such, direct comparisons between farm gate and retail prices are difficult and not necessarily instructive.

The ACCC is satisfied that the market is broadly competitive at all levels of the supply chain.

Beef is an internationally traded commodity with 65 per cent of Australian production exported. As such, international beef prices strongly influence returns to Australian producers. It does not appear that any domestic purchasers have significant buyer power with the two largest domestic purchasers, Coles and Woolworths, each only purchasing around six per cent of domestic production.

There appears to be competition at all levels of the supply chain, including the retail level where Coles and Woolworths share of sales is significantly lower than for many other standard grocery items. Retail beef prices have increased at roughly the same rate as CPI over the last six years.

Retail gross margins on beef are low by comparison to most other categories of products sold by the MSCs further suggesting strong retail competition. The ACCC cannot rule out that there may be some competitive weaknesses in some geographic regions, but any weakness is likely to manifest itself in the form of lower returns to producers rather than higher prices to consumers.

198 ABS, *Average retail prices of selected Items, Eight capital cities,* December 2007 and March 2008.

199 ALIC information provided to DAFF in the form of monthly statistics that includes beef retail prices. ALIC is a government development agency for Japan's agriculture and livestock industries.

13 Farm gate and retail pricing

Key points

- Evidence available to the inquiry does not support the proposition that retail prices have risen while farm gate prices have stagnated or declined.
- Generally speaking, movements in the wholesale price are reflected in movements in the retail price.
- In general, retail prices of food in Australia are going up faster than the CPI, but this is not universal across all product categories or even within categories. Farm gate prices for some products have risen substantially in recent years in response to international factors while others have fallen. These effects have generally, but not universally, been reflected in retail prices.
- Evidence available to the inquiry suggests that retailers do not set farm gate prices, but rather these prices mirror supply and demand factors in the relevant market. In general, the MSCs do not buy sufficient amounts of product to control the market price; however, there may be some categories where it is possible for the MSCs to significantly influence price in certain periods.
- Reasons that retail prices do not always fall in line with farm gate prices are varied and depend on the category of product being examined.

13.1 Introduction

A significant concern raised at hearings and in submissions to the inquiry is whether the 'gap' between farm gate and retail prices for groceries has been widening in recent times. For example, the Queensland Farmers' Federation believes:

> … it is important for the ACCC to consider why food prices paid by consumers have been rising much faster than the prices paid to farmers. Over the last four years to June 2006, retail food prices had risen on average by 17.8 per cent while average prices received by farmers rose by just 2.3 per cent. Food prices also rose much faster than inflation, with 17.8 per cent for food compared to 12.1 per cent for everything else. These increases have not been felt by farmers, who over the same period, have been struggling with the worst drought in a century which saw their cost of production rise by 16.5 per cent.
>
> Food prices are not delivering fair results for either consumers or farmers. Farmers have little market power and are known to be price takers; taking whatever price is imposed by the big retail chains, wholesale agents, processors and the world markets. There is also a clear trend for the major retailers to use their market power to push costs, risks and responsibilities back down the supply chain. Producers' profit margins continue to decrease, while the profit margins of the major retailers remain at record highs. [1]

1 Queensland Farmers Federation, submission no. 93, p. 1.

On the other hand, the National Farmers' Federation (NFF) noted that there will not necessarily be a direct and immediate relationship between the price of the raw farm product or input and the final good. The NFF stated:

> It has long been a frustration for agricultural producers that our sector attains only a small portion of the end retail price of food products. Indeed, a study by Whitehall Associates in 2004 titled Price Determination in the Australian Food Industry, found that the farm-gate component of the retail price of a basket of food products ranged between 5 per cent and 40 per cent. They also indicated that there appeared to be an increasing gap between farm-gate and retail prices.
>
> While market concentration and competition issues cannot be discounted as being part of the reason behind this increasing gap, the NFF also acknowledges that there is an array of supply chain costs pressures that are being felt by the non-farm sectors which help the consumer to access the end food product. Such costs include marketing, transport, processing, packaging and labelling. [2]

The ACCC considers that there are broadly three possible competition-related reasons that may explain any increasing gap between farm gate and retail prices:

- a lack of competition at the retail level, giving the retailers an increasing degree of discretion in their retail pricing
- a lack of competition or increasing market power at other points in the supply chain
- the buyer power of the major supermarket chains (MSCs), derived in part from their market share, altering profit distribution along the supply chain but not increasing prices above competitive levels.

The first point has been explored in the first half of this report. The second point has been analysed in the context of the case studies contained in chapter 12 of this report. The third point will be examined in more detail in chapter 15.

The purpose of this chapter is to examine the material available to the ACCC on the question of whether there has been an increasing gap between farm gate prices and retail prices of grocery products. Given difficulties in examining the relationships between farm gate prices and retail prices at a broad level, the ACCC has focussed its analysis on a number of product groups. These have primarily drawn from the case studies detailed in chapter 12. In addition, evidence of an increasing gap between farm gate prices and retail prices is assessed with regards to changes in the gross margins of the MSCs and other retailers.

13.2 The 'gap' between farm gate and retail prices

The 'gap' between farm gate and retail prices represents the difference between the price paid to the primary producer of a product and the retail price paid by the consumer. The size of the gap is determined by the relative contribution that the following factors make to the retail price of the product:

- the costs associated with turning the 'raw' product into the product found on supermarket shelves—for example, raw milk and livestock require processing before they can reach consumers but eggs are already in their final state
- costs associated with transport, storage, handling, distribution and retailing, including the degree to which some of the product may be lost in the transformation process—for example, spoilt fruit and vegetables and breakages
- the mark-up applied by each party along the supply chain.

2 National Farmers Federation, submission no. 137, p. 7.

13.2.1 Evidence of the gap between farm gate and retail prices

Comparisons between farm gate and retail prices are difficult for several reasons. Most products go through a number of stages of production. Moreover, in many cases, costs of individual ingredients make up a small proportion of the retail price of the product.

As a result, it is difficult to isolate the relationship between movements in the prices of primary products (such as grain) and the retail price of final product (such as bread). In these cases, it cannot be said that a decrease in farm gate price should necessarily cause a corresponding decrease in retail prices. Various other factors, including changes in processing and transport costs, also affect retail prices.

In other cases, where there is minimal processing of the final product (such as with fresh fruit and vegetables), the relationship between farm gate and the retail prices is more observable.

Milk

According to the CPI published by the ABS, the consumer (retail) price of milk increased at a broadly steady rate of around 5 per cent per annum from March 2002 to March 2008.[3]

As discussed in chapter 12, the farm gate price of milk has been more volatile than the retail price (see chart 12.1). This makes comparisons of the retail and farm gate prices susceptible to the period chosen. After dropping significantly in 2002–03, farm gate prices increased at around the same rate as retail prices between mid-2003 and mid-2007. Since the middle of 2007 the rate of increase in farm gate prices has significantly outstripped the rate of increase in retail prices.

There is no evidence that processors and retailers are able to suppress farm gate pricing in the face of rising world dairy prices, nor are they free to pass on every cost increase that results from increases in farm gate pricing. This is consistent with strong competition at each level of the chain.

Eggs

According to the CPI data published by the ABS, the retail price of eggs, after declining steadily between June 2003 and June 2005, increased at a rate above the CPI and above the food CPI until March 2008.[4]

The farm gate price of eggs followed a broadly similar pattern: farm gate prices declined between 2003 and 2005 and then rose strongly between 2005 and 2008.[5] However, the decline in farm gate prices appears to have commenced before the decline in retail prices.

When plotted as an index (as in chart 12.11) there appears to be a strong, but not uniform, relationship between movements in the retail price and movements in the farm gate price. Given how little transformation occurs between the farm gate and the retail level for an egg, this correlation is to be expected.

Based on the material available to the inquiry, it would appear that there was an increasing gap between farm gate and retail prices of eggs between 2003 and 2005 but, since then, the gap has narrowed and egg producers are now receiving a higher proportion of the retail price than they did in 2001.

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3 ABS cat. no. 6401.0 (2008).

4 Chart 12.11.

5 ABARE Australian Commodity Statistics 2007, pp. 22–23; and for March 2008 see Chart 12.10.

Accordingly, for eggs, it is not true to say that there is an increasing gap between the farm gate price and the retail price. The rapid increase in the price of eggs over the last three years appears to be the product of increasing costs for the producer and not an increase in producer or retailer margins.[6]

Red meat

According to data published by ABARE, the increase in the farm gate price of cattle between March 1998 and March 2008 of 85 per cent exceeded the increase in retail prices for beef of 60 per cent.[7] As with milk, different impressions about the gap between farm gate and retail prices can be gained by looking at data from one year to the next. This results from the more volatile nature of farm gate prices.

It would appear that the farm gate price of beef cattle has risen faster than retail prices over the last 10 years, notwithstanding the strong submissions to the contrary the ACCC has received on this issue. This raises the question of why this perception exists. For beef, that question is difficult to answer comprehensively; however, it may be the product of the highly volatile farm gate and wholesale markets for beef compared with a more consistent retail market which smoothes out the price increases to consumers. The result of the volatility is that in a single year farm gate prices can surge by more than 25 per cent (as they did in 2003), but retail prices rise by only 5 per cent. In later years, as farm gate prices start to decline and retail prices continue to rise (but only to levels which bring retail returns back to levels enjoyed before the price surge) concerns are raised about retail pricing.

Even if there is more foundation to claims that the gap between farm gate and retail prices for beef are growing by more than the ABARE data suggests, the ACCC is confident that, to the extent that there is any divergence between farm gate and retail prices of beef, any increase in retail price is not as a consequence of the retailers earning excessive margins. The gross margins in meat achieved by the MSCs appear to be relatively low as a category and have declined overall over the past five years. Accordingly, any problem that may exist is not a competition problem at the retail level.

Fruit and vegetables

A pattern of retail prices rising in line with wholesale prices has been generally observed in fruit and vegetables.

The discussion below relies heavily on wholesale market data as a proxy for farm gate price data for fresh produce. The ACCC has been unable to obtain accurate farm gate data as a result of the vast numbers of growers producing fresh produce in Australia. Such a data collection exercise was not able to be performed in the time available to the inquiry. As a result, the ACCC has performed the analysis below on the basis of wholesale market prices, for which the ACCC has been able to obtain accurate data.

The ACCC acknowledges that there is some difference between farm gate and wholesale market prices as a result of growers having to pay agents fees, and potentially some transport costs. However, the ACCC is satisfied that the trends observed will be reflective of movements in the farm gate price. The ACCC considers that wholesale market data is a reasonable replacement for farm gate data for the purposes of the analysis below.

Charts 13.1 and 13.2 indicate that the retail price of eight key standard fruit and vegetable products examined has moved in a pattern generally consistent with movements in the wholesale price.

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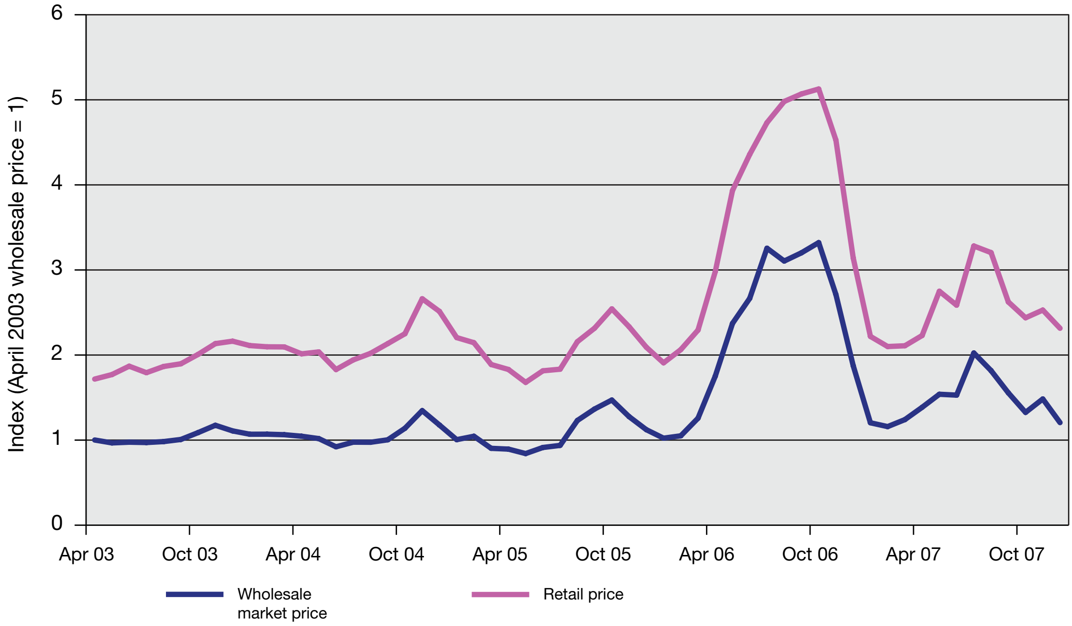
6 See 12.5.9 for more detailed discussion of retailer margins.

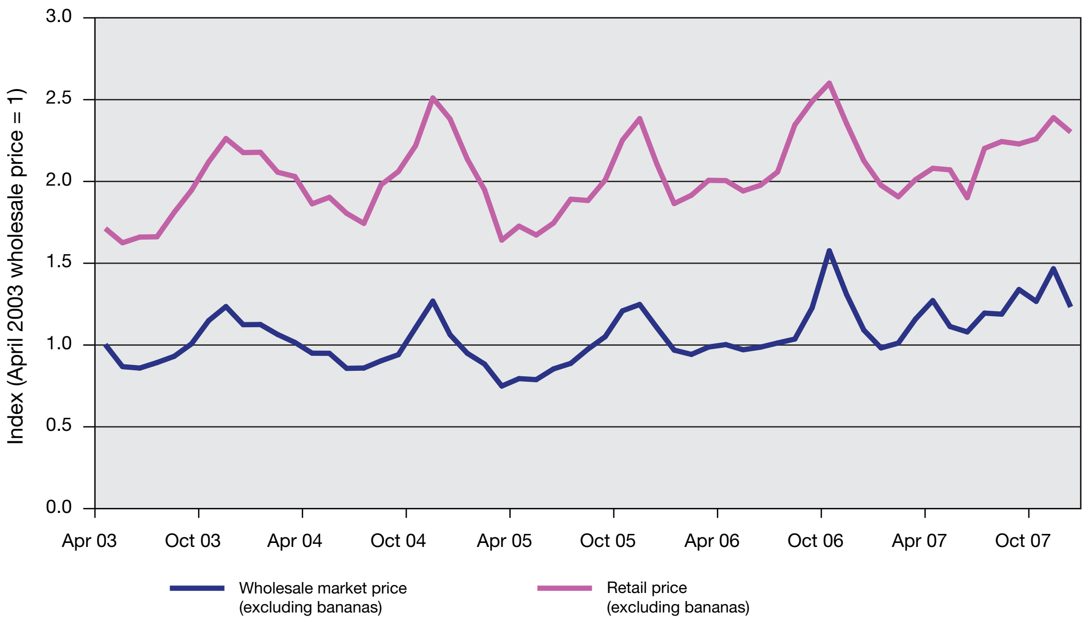
7 ABARE, *Australian commodity statistics 2007*, available at www.abare.gov.au/publications_html/acs/acs_07/acs_07.pdf. Retail price data obtained from ABS, the ACCC believes that this data actually overstates the rises in retail price and therefore the retail price increase is likely to be lower. See chapter 12.8 for a further discussion on this topic.

Chart 13.1 Retail to wholesale price fluctuations from April 2003 to December 2007 for eight fruit and vegetable products



Source: Wholesale data obtained from Ausmarket, average retail price data obtained confidentially from Coles and Woolworths

Chart 13.2 Retail to wholesale price fluctuations for seven fruit and vegetable products (those considered in chart 13.1 excluding bananas)

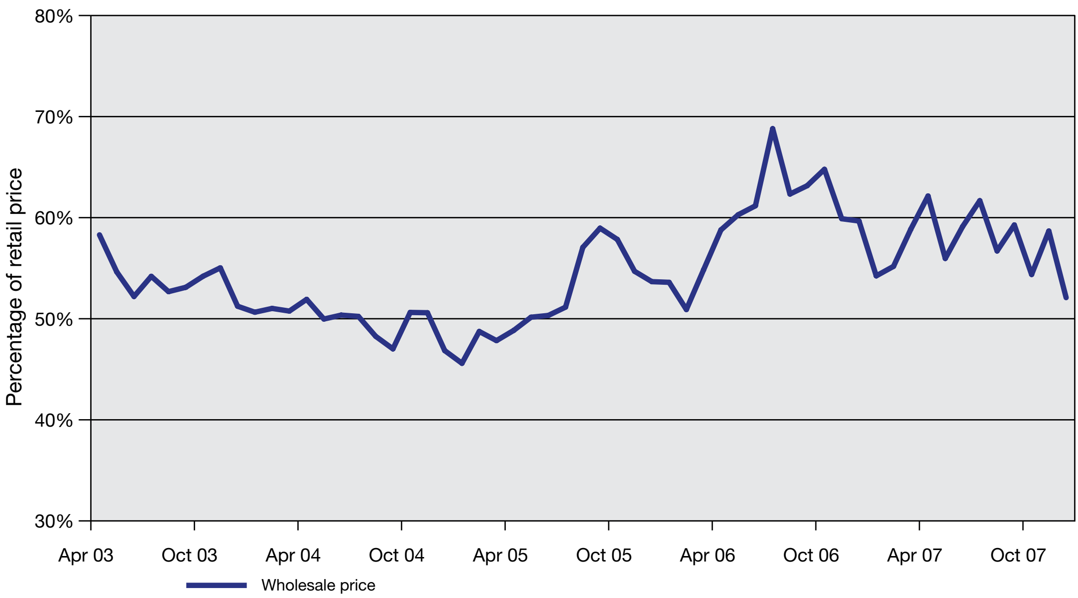


Source: Wholesale data obtained from Ausmarket, average retail price data obtained confidentially from Coles and Woolworths

Chart 13.3 displays the wholesale price as a proportion of the retail price. While for most of the period the wholesale price has constituted between 50 and 60 per cent of the retail price, there have been extended periods (between August 2004 and June 2005) where the wholesale price as a proportion of the retail price of fruit and vegetables stayed below 50 per cent. The wholesale price as a proportion of the retail price only went above 60 per cent after cyclone Larry.

Care must be taken in interpreting the retail margins captured in chart 13.3 as they can vary widely with wholesale prices. If wholesale prices increase sharply and the retailers maintain the same margin in dollar terms, then the percentage retail margin will fall. This is a major source of the variation in the margins displayed in chart 13.3. It is not surprising that the wholesale price as a proportion of retail prices increased during cyclone Larry. There should be no reasons for retailers to mark-up bananas by the same percentage when the wholesale price of bananas spiked after cyclone Larry.

Chart 13.3 Wholesale prices as a percentage of MSC retail price for eight fruit and vegetable products



Source: Wholesale data obtained from Ausmarket, average retail price data obtained confidentially from Coles and Woolworths

In broad terms, the charts indicate that, contrary to information provided in a number of submissions to the inquiry, retail prices are not rising sharply while farm gate prices are static. Movements in fruit and vegetable retail prices are broadly in line with price movements in the wholesale market. There is no evidence that the MSCs or any other player in the market can hold down wholesale prices while increasing retail prices.

Moreover, the MSCs' gross margins in produce have actually declined since 2002–03. This suggests any increase in the gap between farm gate and retail prices for fruit and vegetables is not through higher retail margins of the MSCs.

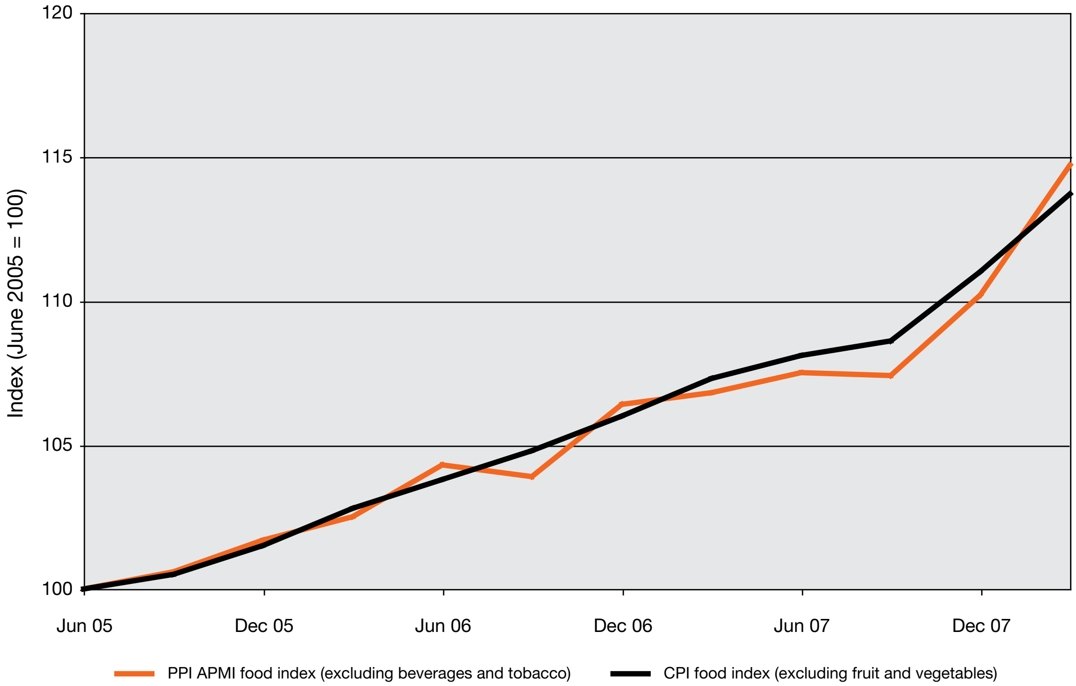
There is very little data to suggest a decline in farm gate prices for fruit and vegetables that is not linked to supply and demand conditions prevailing in the relevant market at the relevant time.

It is easy to look to the MSCs given their size and related buying power and assume that this is leading to a widening of the gap between farm gate and retail prices. However, the data available to the ACCC certainly do not support that as a universal picture. Indeed, the data contradicts it in many fruit and vegetable categories.

Manufactured food

The wholesale and retail prices of manufactured food products seem to track each other more closely than the prices of fresh food products. Chart 13.4 compares the producer price index (PPI) series for Australian manufacturers of food products (excluding beverages and tobacco)[8] and the CPI data for food (excluding fruit and vegetables which are not included in the PPI). Since June 2005, changes in the retail prices have tracked fairly closely with the changes in ex-factory prices received by producers—though the series do diverge from time to time, as noted by the ABS.[9]

Chart 13.4 ABS consumer price index and produced price index (articles produced by manufacturers industries) food indexes



Note: The PPI series above excludes fresh produce as it does not pass through manufacturers. The procedures used to construct these price indices are largely identical to those used to compile the CPI.

Sources: ABS (cat. no. 6401.0); ABS (cat. no. 6427.0)

8 The producer price index (PPI) is a measure of the change over time of both the prices paid by producers for their inputs (the materials used in the production of their product) and the prices they receive for their product (ABS cat. no. 6427.0). The PPI excludes sales to other manufacturers for further use in the production of other goods. For this analysis, the PPI has been adjusted to exclude beverages and tobacco to bring it into line with the CPI food series (alcoholic beverages have a significant effect on the PPI; however, alcohol is not included in the CPI food series so beverages have been excluded from PPI).

9 ABS, submission no. 245, p. xiii.

13.2.2 Margins of retailers

An additional method in examining whether there is an increasing gap between retail prices and the wholesale prices received by producers is to assess changes in the gross margins (revenue achieved from sales minus the cost of goods sold) that the MSCs and other retailers are earning over time from supermarket operations. The ACCC considers that an increasing gap between retail and wholesale prices would be reflected in increasing gross margins. This issue was analysed in chapter 6 of the report.

In chapter 6 the ACCC found that the trends in gross margins achieved by the MSCs were mixed. Overall, Woolworths has increased its gross margins over the last five years, while Coles has experienced relatively flat gross margins. However, the trends in gross margins differed quite significantly for different trading departments within the same company.

In particular, both MSCs were able to achieve increases in gross margin for dry groceries and perishables such as dairy products from 2002–03 to 2006–07. The increases in the gross margins for these categories were fairly constant year on year.

The increase in dairy margins is likely a result of the MSCs putting pressure on profits at the processor level given that retail price rises have been broadly consistent with rises at the farm gate. Comparatively, the MSCs gross margins for meat and fresh produce declined over the same period. Trends in gross margins for bakery and deli categories were more varied. These varying trends in gross margin may be related to the different competitive pressure in each category.

13.3 Conclusions

The ACCC considers that there is no broad observable trend relating to an increasing gap between farm gate (or wholesale) prices for fresh produce and retail prices. There are a number of product categories and numerous products within specific categories where retail prices have actually remained stagnant or have risen at a slower rate than farm gate prices.

This general conclusion is consistent with the observable structure of most of the markets in which the MSCs operate. While the MSCs seem large as a proportion of retail spending, as a destination for farm produce they are much smaller in most categories. As buyers, Coles and Woolworths compete with other grocery retailers (including specialty stores), as well as the food service industry, the food processing industry and export markets. In categories such as beef, the MSCs only buy around 12 per cent of Australian production.[10] Accordingly, the ACCC considers the structure of the grocery sector does not lend itself to allowing the MSCs to artificially suppress farm gate prices.

This is not to say that there are not subcategories within broader food categories (such as yearlings within the beef category) where the MSCs are extremely large players and may, in certain periods, have significant influence over the market. However, the MSCs are not in a position to reduce returns to beef producers below the prices paid internationally. One beef producer acknowledged during the public hearing in Perth that the current concerns with beef pricing would not be so acute if the Australian dollar was trading at US$0.45 instead of US$0.90.[11]

There are, however, some periods where the gap between retail prices and farm gate prices does increase for some products. The exact cause of this increasing gap appears largely dependent upon the circumstances of each particular product category or product.

10 MLA have estimated, using BIS Shrapnel/Roy Morgan data that of the total beef produced in Australia, 35 per cent is not exported and is used for domestic consumption. Of this 35 per cent, 68 per cent is sold through retail channels. Of that 68 per cent, the MSCs purchase 52 per cent.

11 For example, see ACCC, public hearing transcript, Perth, 22 April 2008, p. 57.

14 Buyer power

Key points

- The bargaining power concept of buyer power is more appropriate in most instances than the monopsony power concept for analysing buyer power in Australian grocery retail. The inquiry is predominantly using the bargaining power concept of buyer power, not the monopsony power concept.
- Buyer power in bilateral commercial relationships is primarily the result of the buyer in the relationship having higher value 'outside options' than the seller.
- Buyer power may arise from the relative sizes of the buyer and seller, their relative dependency on the relationship, and other factors that influence the relative values of their outside options.
- But the broader impact of buyer power on economic welfare is still not yet settled in the economic literature. In particular, it is not yet clear if buyer power results in a gain or a loss to consumers. However, if lower supply prices are passed through to consumers in the form of lower retail prices, then this will generally result in a gain to consumer welfare.
- The impact of buyer power will need to be assessed on the specific evidence in each case. Such impacts are looked at more closely in chapter 15.

14.1 Introduction

In recent years, there has been growing concern in Australia and other countries about the levels of consolidation of grocery retailers. In particular, concerns have been raised by suppliers about the extent of the so-called 'buyer power' of retailers. Such concerns typically hold that the size and market dominance of the MSCs means that they are able to source fresh grocery products from farmers and growers at decreasing supply prices without passing on the full benefits to consumers in the form of lower prices, but instead achieving higher margins to the benefit of shareholders.

This chapter examines the potential impact on the retail sector of such buyer power. Chapter 15 considers the evidence relating to the actual extent of buyer power in Australian grocery retail and the actual impact on suppliers and consumers. Changes in retailer concentration are discussed in more detail in chapter 3.

To simplify the language in this chapter, it will refer to retailers only. However, it should be noted that Metcash, although not a retailer, is also a significant purchaser of grocery items from producers and therefore much of the discussion is also relevant to Metcash.

A common element of many of the concerns raised is that retailers are said to be able to use their buyer power to extract more favourable terms and conditions from upstream suppliers than would otherwise be the case. Such an outcome may disadvantage suppliers. In the context of this inquiry, this would mean the retailer's bargaining power (relative to the supplier's bargaining power) is increased when negotiating trading terms for supply of groceries.

An associated concern increasingly been given attention in the theoretical economic and industry analysis literature is that of the large grocery retailer as 'gatekeeper' between large numbers of suppliers and final customers. A typical concern regarding this gatekeeper role is that big retailers supposedly use their buyer power to drive down prices paid to small suppliers of supermarket goods (particularly primary producers, such as farmers, growers, etc.) in an allegedly anti-competitive manner.

Such concerns and complaints have contributed significantly to the motivation behind several related inquiries in Australia, the United Kingdom (UK) and other countries. As with many other aspects of grocery supply, the mere existence of buyer power does not mean competition is necessarily weakened and that consumers will be worse off. Thus it is necessary to examine the impact of buyer power on a case-by-case basis.

This chapter considers the following issues:

- What is buyer power? What frameworks are suggested by economic theory for the analysis of buyer power?
- What are the potential sources of buyer power? Does the size of MSCs and other large buyers mean that they can exercise buyer power in their dealings with farmers, growers and other groceries suppliers?
- When might buyer power be of concern and when may it be beneficial to consumers?
- How has buyer power been analysed by the ACCC and the Australian courts?

This chapter sets up the framework for the assessment of the evidence on buyer power that has been presented to this inquiry and is considered in the following two chapters.[1]

14.2 What is buyer power?

A broad definition of buyer power is that it is the ability of a person to exercise power in a market in which they are a buyer.

A typical manifestation of buyer power is the ability of the buyer to influence the price it pays for goods and services. In the context of grocery retailing, buyer power therefore would refer to a grocery retailer's ability to influence the price it pays to suppliers (manufacturers, growers, etc.) of grocery products, which the retailer then on-sells in its stores. This means the retailer has some degree of market power, concurrent with the OECD definition of buyer power as being 'the ability of a buyer to influence the terms and conditions on which it purchases goods'.[2]

Buyer power is typically manifest as the buyer's ability to purchase a good or service at a price below the price at which it would trade in a perfectly competitive market, that is, as:

> the ability of a buyer to reduce the price profitably below a supplier's normal selling price, or more generally the ability to obtain trade terms more favourable than a supplier's normal trade terms.[3]

A typical situation where such buyer power may exist is where 'the demand side of a market is sufficiently concentrated that buyers can exercise market power over sellers'.[4]

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1 This chapter is predominantly a discussion of the economic theory underlying the analysis of buyer power. This economic framework is used by the inquiry to analyse the evidence presented to the inquiry, and this analysis of the evidence is presented in the next two chapters. The theoretical evidence referred to in this chapter is not necessarily applicable to the Australian grocery sector but serves to illustrate the uncertainties that can arise in an economic assessment of buyer power. Further, not all of the issues discussed in this chapter have emerged as issues of concern in this inquiry on the basis of the evidence put before the inquiry. The concerns that have emerged are discussed in the next two chapters, in the context of the evidence submitted to the inquiry and analysed in those two chapters.

2 OECD, 'Buying power of multiproduct retailers', Series roundtables on competition policy, DAFFE/CLP(99)21, 1999, p. 18.

3 Z Chen, 'Dominant retailers and the countervailing power hypothesis', *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25.

4 RG Noll, '"Buyer power" and economic policy', *Antitrust Law Journal*, vol. 72, 2005, pp. 589–624, at 589.

It should be noted that concerns about the competition effects of buyer power are related to, but also in a sense stand in contrast to, more common competition concerns about monopoly power or seller's market power, where seller-side market power is commonly conceived of as being 'the ability of a firm to profitably set price[s] above competitive levels'.[5]

14.3 How should buyer power be characterised?

The economic literature conceives of and analyses buyer power in essentially two distinct ways. The first conception is of buyer power as being monopsony power, meaning that a buyer has market power in the context of a single arm's length market consisting of a number of buyers and sellers. The second is of buyer power as being bilateral bargaining power, meaning that a buyer has bargaining power in the context of bilateral supply relationships between individual buyers and sellers.

These two essential characterisations—and the analytical work that flows from and is built on them—share some characteristics; however, they depart from each other in important ways and give rise to different sets of analytical implications.

This inquiry adopts (in most instances) a bilateral bargaining power model to analyse buyer power in grocery retail. This is because a bilateral bargaining power model of buyer power more fully reflects the structural features of most upstream grocery supply industries and more accurately predicts the observed outcomes of negotiations. Essentially, the bilateral bargaining model is more appropriate for analysing commercial situations where buyers and sellers interact in a series of one-on-one bilateral relationships. This is the predominant situation in Australian groceries supply. The monopsony power model is more apt where buyers and sellers interact in a wholesale market forum, where prices are determined in single markets rather than in individual dealings between buyers and sellers. This is far less often the situation in Australian groceries supply and so is not as a rule used in this inquiry (although the inquiry does use this model for analysis in one instance in chapter 15, where it is appropriate on the facts).

The alternative monopsony power model is outlined in appendix I, as are more detailed reasons for (generally) adopting a bilateral bargaining model in this inquiry.

The bilateral bargaining model is outlined in the next section.

14.3.1 The bargaining concept of buyer power—bilateral bargaining power

The concept of buyer power that the ACCC is using for this grocery inquiry is that of buyer bargaining power.

In this concept buyers and sellers interact and trade by way of a series of direct bilateral relationships, rather than trading in a market setting at arm's length. Buyers and sellers in principle negotiate and conclude commercial deals because they can both realise a benefit from the deal. Bargaining over the terms of a deal in essence is bargaining over how the parties will divide the amount of the total (to both buyer and seller) net benefit from the deal, otherwise known as the 'joint surplus' (between both buyer and seller) from the deal.

5 D Carlton and J Perloff, *Modern Industrial Organization*, Glenview IL: Scott, Foresman, 1989, p. 97.

This bargaining conception is consistent with the way in which retailers in most cases buy groceries from manufacturers, which generally involves negotiation over prices and other trading terms. Retailers (buyers) and suppliers/manufacturers (sellers) negotiate the prices and specific terms on which the product will be sold to the retailer. These terms may vary from buyer to buyer in this framework as terms are determined by negotiation rather than through a single market trading framework.

Furthermore, this bargaining concept is consistent with a wide variety of supply prices, terms and conditions, and does not predict that lower supply prices will be accompanied by lower quantities. This is in contrast to the monopsony power model, which predicts that lower supply prices will be accompanied by lower supply quantities relative to the competitive outcome, for instance, through withheld demand by a powerful buyer (see appendix I for further details on the monopsony power model).

The relative bargaining power of buyer and seller will be an important determinant in the outcome of negotiations over the supply price (and other terms) between buyer and seller. Bargaining power in a bilateral bargaining relationship is best described as being exercised by threatening to impose a cost, or to withdraw a benefit, if the other party does not grant a concession—for example, a price discount. Buyer power in this context is the ability of powerful buyers to exercise bilateral bargaining power against less powerful sellers to negotiate more favourable price discounts and other favourable terms in these individual supply relationships than would be negotiated in the absence of buyer power.

A simple theoretical bargaining model is contained in appendix I. That model highlights the 'outside options' concept. This is one of the key concepts in an assessment of buyer power and bilateral bargaining. Put simply, the outside option is the best option that either the seller or buyer can achieve if they walk away from the negotiations. These walk-away options are the minimum negotiated outcome that the respective parties will accept.

For example, from the supplier's perspective, there may be a range of outside options, including export to overseas retailers, supply to other domestic retailers (including those in other distribution channels), supply to wholesale markets or direct supply to consumers. For retailers, the outside options may include purchasing from other domestic suppliers or importing from overseas suppliers. In analysing outside options, the whole range of options should be considered.

The more outside options that either buyer or seller has, the stronger will its bargaining position be relative to the other party (all other things being equal). If a buyer and seller are negotiating a supply deal and if the buyer's outside options improve or the seller's outside options deteriorate, the consequence in general will be that the buyer will have improved bargaining power and will be able to capture a greater share of the joint net benefit, or joint surplus, arising from the deal between buyer and seller.

The general result is that the strong outside options for a buyer, or weak outside options for a seller, are a major source of buyer power in a bilateral bargaining framework.

Complications to bargaining power models

Bilateral bargaining typically does not occur in isolation. Even though retail supply contracts are typically bilateral, large retailers often negotiate simultaneously with a large number of suppliers, and suppliers negotiate with more than one retailer. Consequently, bargaining can be influenced by these other simultaneous negotiations, with a commensurate impact on the outside options available to both of the parties involved in the direct negotiations. For instance, if a retailer was simultaneously negotiating with a number of potential alternative suppliers for a particular product, then this would in general be likely to improve the retailer's outside options and, thereby, its bargaining power with each of the suppliers. Similarly, if a supplier was negotiating with a number of potential alternative buyers, this would in general improve its outside options and its bargaining power.

Bargaining outcomes in retail grocery supply can also be influenced by the degree of downstream competition from other retailers. This will be likely to affect the outside options of both the supplier of the grocery item, and the buyer/retailer.

- For the seller, a significant component of the outside option is the extent to which that supplier can instead place its products on the shelves of competing grocery retailers as an alternative way of reaching the final consumer. The greater the downstream competition, the greater the opportunities will be for the supplier to place its product on another retailer's shelves, which means that there is less chance that the supplier will lose sales by foregoing supply via a specific retailer. This means that a more competitive downstream retail industry will generally give a supplier greater outside options, and therefore greater bargaining power.
- The grocery retailer's typical walk away option is to delist the supplier's product or to refuse to accept a new product. The value of this outside option will depend on the impact the absence of the item from the retailer's shelves will have on final consumers. If a retailer delists a supplier's product, to what extent can this induce customers to switch to an alternative retailer? The more consumers value a specific brand or item etc., the greater the **incentive** will be for consumers to switch retailers. Similarly, the greater the extent of downstream competition, the greater the opportunity is for consumers to switch retailers, which increases the chance of them doing so (all else being equal).

A corollary implication is strong brands may have appreciable countervailing selling power. For instance, it has been observed that ALDI in Australia, which stocks predominantly products under its own in-house labels, nonetheless stocks a small number of very well known branded products (in particular, Vegemite, which is produced by Kraft, and Nescafe, which is produced by Nestle). The reason may be that certain specific brands command such brand loyalty that their absence from the shelves would be reason enough to induce some consumers to change retailers. This would have strong implications for the countervailing power of the suppliers of such goods in respect of bilateral bargaining between these suppliers and retailers.

Factors other than outside options may also influence the conduct and outcome of bilateral bargaining between suppliers and retailers. These factors include:

- **The role of information**: are there information asymmetries regarding the different parties' knowledge of the other parties—for instance, regarding other parties' cost structures? An informational advantage may give rise to an advantage in terms of bargaining power.
- **Coordination (tacit or explicit) among suppliers**: the presence of incentives for suppliers to undercut any supplier collusion (e.g. to obtain a large order from a retailer) may increase buyer bargaining power.[6]

6 For a formalisation of this notion, see C M Snyder, 'Why do large buyers pay lower prices? Intense supplier competition', *Economics Letters*, vol. 58, 1999, pp. 205–09.

14.4 Possible sources of buyer bargaining power

This section examines the possible sources of buyer power that have been analysed in the economic literature and provides a framework for assessing the evidence that has been presented to this inquiry about possible buyer power.

14.4.1 Absolute size of buyer

A commonly cited source of buyer bargaining power is the absolute size of the buyer. The typical notion is the larger the buyer, the greater its bargaining power. However, there is also persuasive empirical evidence that mere size alone does not, in and of itself, confer buyer bargaining power, but rather that the bargaining power may be more closely related to the size/value of the relative outside options than it is to the respective sizes of the firms alone.[7]

A commonly cited reason is that a larger firm size may increase the value of the firm's outside options, which will increase the firm's bargaining power (in the context of bargaining models—e.g. the simple model outlined in appendix I). Alternatively, if the larger is a buyer, the lower will be the value of the outside options of the sellers with which it trades (all else being equal).

One proposed reason for the improved outside option value of a larger firm is that the firm may have more attractive alternative sources of supply than a smaller firm, thereby increasing its outside options and its bargaining position. A different way of viewing this is that a larger firm, with its better range of alternative suppliers, may therefore be able to more credibly threaten to find alternative suppliers during negotiations, which will similarly improve its bargaining position.

Closely related to this is the idea that a larger firm might be better positioned to make a credible threat (during negotiations) of producing its own private label products (as an alternative to proprietary branded products) as an outside option. It is argued that a larger buyer may be able to make a more credible threat of such backward integration into its own private label production, which means that a larger buyer may have a better bargaining position (everything else being equal) than a smaller buyer.[8]

It has further been proposed that the presence of large buyers may increase the threat of entry by additional alternative suppliers, and that this may in turn lead to the large buyer being able to make more credible negotiating threats that it will sponsor the entry of such new alternative suppliers.

Finally, it has been proposed that size disparities between a large buyer and a small supplier can bring about differences in bargaining power—for example, if negotiations with the large buyer were to break down, the small supplier could find it difficult to find alternative buyers for the quantities of stock in its possession.[9]

14.4.2 Relative dependency on the relationship

A second possible, and potentially important, source of buyer power raised in the economic literature is the relative dependency of two parties on a particular buyer–seller relationship. The idea is that, where

7 See S F Ellison and C M Snyder, 'Countervailing power in wholesale pharmaceuticals', MIT Department of Economics working paper, no. 01–27, 2001.

8 See, for example, M L Katz, 'The welfare effects of third degree price discrimination in intermediate goods markets', *American Economic Review*, vol. 77,1987, pp. 154–67; and D T Sheffman and P T Spiller, 'Buyers' strategies, entry barriers, and competition', *Economic Inquiry*, vol. 30, pp. 418–36.

9 See, for example, R Inderst and C Wey, 'Buyer power and supplier incentives', *European Economic Review*, vol. 51, 2007, 647–67.

a buyer and a seller are in a supply bilateral relationship and the relationship is of substantial financial importance to the seller but of lesser importance to the buyer, this will impart bargaining power on the buyer.

This may occur for two separate but interrelated reasons. First, where there is an unequal relative dependency on the relationship, there is likely to be an asymmetry in the respective consequences should either party walk away from the relationship. If the buyer walks away from negotiations, the consequences for the seller would be significant—whereas the consequences for the buyer of the seller walking away would be less significant. Second, because the consequences for the buyer of walking away are not significant, any threat by the buyer to walk away from negotiations would be a credible threat. The interrelationship of these two factors in the case of a relatively dependent seller and a relatively non-dependent buyer would result (all else being equal) in the buyer having greater bargaining power than the seller.

The effect of asymmetric relative dependency on the relationship is captured in an OECD definition of a retailer having buyer power, which states that a:

> … retailer is defined to have buyer power if, in relation to at least one supplier, it can credibly threaten to impose a long term opportunity cost (i.e. harmful or withheld benefit) which, were the threat carried out, would be significantly disproportionate to any resulting long term opportunity cost to itself. By disproportionate, we intend a difference in relative rather than absolute opportunity cost, e.g. Retailer A has buyer power over Supplier B if a decision to delist B's product could cause A's profit to decline by 0.1 per cent and B's to decline by 10 per cent.[10]

There are several factors which are helpful in identifying this type of buyer bargaining power. Firstly, the relative shares of economic return for the buyer and seller, which are dependent on the relationship with the other, can be analysed. Dependency in this sense includes both direct and indirect dependence, and extends to that share of return which would be lost if the other party walked away from the relationship. Secondly, how readily a supplier can replace the buyer as a customer, and similarly how easily the buyer can replace the buyer as a source of supply, can be examined.

14.4.3 Impact of private labels

If the buyer has its own private labels that compete with the seller's product (or if the buyer can readily create and have manufactured such private label goods), then this is likely to be a further source of buyer power.

This is because if a buyer has private labels that compete with the supplier's products, its outside options are improved, thereby increasing its bargaining power relative to the supplier. Furthermore, even if the buyer does not have private label products that compete with the supplier's goods, the mere credible threat to integrate backwards and produce its own competing products can impart increased relative bargaining power on the buyer (see 14.4.1). Where a buyer already has private label goods in other ranges, this may enhance the credibility of any threat by the buyer to integrate backwards into a range of goods that compete with those of the supplier in question.

The actual impact of private labels on bargaining power is also likely to depend on consumer preference. For instance, if consumers do not view private label products as being close substitutes for a supplier's proprietary branded products, the supplier's bargaining power will not in general be as adversely affected as if consumers viewed the products as close substitutes. Furthermore, and closely

10 OECD, *Buyer power of large scale multiproduct retailers*, background paper by the Secretariat, Roundtable on Buying Power, Paris, 1998, para 20.

related to the last point, when consumers show strong brand loyalty to a supplier's products, this generally enhances the supplier's bargaining power when negotiating with grocery retailers buying its products.

The actual impact of private labels on retailers' bargaining power needs to be evaluated on the evidence relating to a particular market. The ACCC notes that there is some empirical economic evidence that private label goods do in general bestow greater bargaining power on retailers.[11]

Private labels and the competitive effects they have in the industry are explored in detail in the chapter 16.

14.4.4 Consumer behaviour

Consumer behaviour is also a possible source of buyer power. One of the constraints on the behaviour of retailers is the ability of consumers to switch to another retailer if their preferred items are not stocked by the retailer.

A key factor in the strength of this constraint on a particular retailer (and a particular item) will be the importance to consumers of the particular item, and how willing and able consumers are to substitute a similar item (e.g. a different brand of the same product, or a private label version).

A consumer whose favourite product is de-listed by their habitual retailer or whose habitual retailer prices higher than competitive retailers may decide that they are better off shopping elsewhere on the basis of a whole range of factors that influence choice of retailers (price, convenience, etc.). In other words, a consumer may engage in 'efficient switching' to another retailer or set of retailers.

However, such efficient switching by consumers may be restrained to some degree by two typical characteristics of consumer behaviour.

Firstly, consumers tend to exhibit one-stop shopping behaviour. For a variety of reasons (including direct costs, such as travel costs and time costs), consumers typically tend to prefer to do their routine shopping at fewer rather than more—and often only one—locations (all else being equal).

Secondly, consumers tend to exhibit some inertia in their shopping behaviour, again for a variety of reasons (including search costs, direct costs, and forces of habit). A consumer's responsiveness to de-listing of items by their preferred retailer may therefore be somewhat dampened.

Furthermore, such efficient switching by consumers in response to price changes and product de-listings may also be limited by information bounds. Supermarkets and large retailers stock a vast range of items. Consumers may not know or be able to process the full range of availabilities and prices at their preferred retailer and its competitors. Indeed, it may be entirely rational for consumers not to obtain the full set of information that would be needed for efficient switching among retailers, given that obtaining, absorbing and processing such a vast amount of data could well be costly in terms of direct costs, time costs and effort. Nonetheless, such a 'boundedly rational' limit on the information that consumers obtain and process may mean that consumers do not efficiently switch between retailers, and remain loyal to retailers even where another retailer offers a better over-all deal, because the consumer does not have all the information regarding better deals at hand.

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11 For a survey of the evidence, see R Inderst and N Mazzarotto, 'Buyer power in distribution', chapter in the ABA *Antitrust Section Handbook*: *Issues in competition law and policy* (W D Collins, forthcoming).

14.5 Possible consequences of buyer power

This section discusses the possible consequences of buyer power, as they have been discussed in the economic literature, on:

- final retail prices and consumer welfare
- suppliers (generally)
- other (e.g. non-favoured or non-integrated) suppliers
- other retailers.

14.5.1 Impact on retail prices and consumers

If a retailer has upstream buyer power, this will typically permit the retailer to buy goods more cheaply. What will be the flow-on consequences of this buyer power on final retail prices (to consumers) and consumer welfare?

Broadly, there are two competing explanations in respect of the impact that buyer power will have on retail consumers.

In the more benign explanation (from a consumer's perspective), retailers pass lower supply prices on to final consumers by way of retail prices. The typical narrative is that the retailer with buyer power upstream can reduce its buying costs (through decreased input prices by bargaining power or by vertical integration, or both), then pass these discounts on (fully or partially) to its retail customers, thereby lowering retail prices, as compared with a situation where the retailer has no buyer power. The lower retail prices confer a net benefit on consumers (that is, consumer surplus is increased) compared with a situation where the retailer does not have market power.[12]

By contrast, in the more malign explanation, the input cost savings are not passed on to consumers but, rather, absorbed by the retailer in the form of increased returns. The typical narrative of this explanation is that the retailer with upstream market power (enabling input cost savings) may also have downstream market power, which enables the retailer to not decrease (and perhaps even increase) the downstream retail price to final consumers. The higher retail price imposes a net cost on consumers (that is, consumer surplus is decreased) compared with the situation where the retailer does not have market power.

Formal economic theory in the area of buyer power and its consequences is still developing, and while it provides some assistance in enabling the relative merits of these two alternative narratives to be analysed, this is not yet conclusive.

One stream of economic models produces results broadly in sympathy with the benign explanation. Certain economic modelling demonstrates that, assuming downstream competition and other plausible assumptions and conditions, a decrease in input prices will be passed on (at least partly) to consumers in the form of lower retail prices, and that this will result in an increase in consumer welfare (consumer surplus).[13] Other modelling shows that, when retail is characterised by a single dominant firm with buyer power, along with a competitive fringe of smaller firms, there will be a similar fall in retail prices.[14]

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12 See P Rey and J Tirole, 'A primer on foreclosure', IDEI working papers 203, Institut d'Économie Industrielle, 2003, Toulouse; Z Chen, 'Dominant retailers and the countervailing power hypothesis', *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25.

13 See P Rey and J Tirole, 'A primer on foreclosure', IDEI working papers 203, Institut d'Économie Industrielle, 2003, Toulouse.

14 See Z Chen, 'Dominant retailers and the countervailing power hypothesis', *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25.

However, other economic models featuring oligopolistic competition in retail markets produce more ambiguous results, whereby buyer power can lower or raise retail prices, depending on certain further conditions and assumptions. In particular, certain economic models find that retailers with buyer power will only pass upstream cost savings on to consumers if there is sufficient downstream competition among the different retailers.[15]

In the grocery industry, buyer power may be driven substantially by a lack of alternatives available to the supplier to obtain access to consumers for their goods, resulting from the concentrated nature of grocery retailing. This suggests that models featuring downstream oligopolistic competition may be more applicable to the Australian grocery retailing context.

14.5.2 Impact on suppliers

If a retailer has upstream buyer power, this will typically permit the retailer to buy goods more cheaply. What will be the flow-on consequences of this buyer power for suppliers?

Allegations that buyer power has a detrimental impact on suppliers are a partial motivation for public interest in grocery retail competition, including this inquiry, and other similar national and other inquiries. A common allegation is that buyer power results in suppliers being paid lower prices than they would receive otherwise. Other typical complaints in relation to misuse of buyer power by retailers in their dealings with suppliers include pressure on suppliers to give ‘unjustified discounts’, demands for help against rival retailers, loss-leading behaviour, and retailers charging shelf slotting or listing fees.[16]

The economic analysis of buyer power broadly supports that such reduction in the price paid to upstream sellers may occur.

Where the item is traded in a wholesale market setting, a powerful buyer can reduce its demand and thereby reduce the market price at which the good is traded by all buyers and sellers (see appendix I). Where the item is traded in a series of bilateral buyer-seller relationships, a buyer who has greater bargaining power than the corresponding seller may be able to capture most or all of the joint surplus arising out of the bilateral supply relationship (see section 14.3 and appendix I).

It was noted in 14.3 that bilateral bargaining buyer power may arise in particular where a buyer has significantly better outside options than the seller (the absolute sizes of the buyer and seller, their relative dependency on the relationship, their relative financial fragility and consumer behaviour may also influence the relative bargaining powers of the buyer and seller). A typical situation giving rise to asymmetric bargaining power in grocery retail may be where the supplier has no (or poor) alternative channels through which to supply its product. This situation is more likely to occur (all else being equal) where there is weak or no competition in a local retail market.

14.5.3 Impact on other suppliers and supply prices—vertical integration

Vertical integration (i.e. backward integration or the production of their own private label products) by large buyers may be harmful to suppliers that are independent of the large buyer. Such backward integration—or a credible threat to do so—by the large buyer, and the associated foreclosure (or threat thereof) of the supplier by the large buyer, will generally improve a large buyer’s bargaining position, which enables the large buyer to obtain a lower supply price and/or better other terms and conditions from the independent supplier.

15 See T von Ungern-Sternberg, ‘Countervailing power revisited’, *International Journal of Industrial Organization*, 14, 1996, pp. 507–19; P Dobson and M Waterson, ‘Countervailing power and consumer prices’, *Economic Journal*, 107, 1997, pp. 418–30.

16 OECD, ‘Buying power of multiproduct retailers’, series of roundtables on competition policy, DAFFE/CLP(99) 21, p. 18.

Further, such backward integration and/or foreclosure may in the longer term also have an impact on the structure and costs of the upstream supply market. If independent suppliers exit the upstream market (in response to reduced sales and/or prices), this may ultimately cause an increase in the upstream costs of production. This in turn (all else being equal) may lead to an increase in final retail prices and a consequent decrease in consumer prices.[17]

14.5.4 Impact on suppliers' incentives to invest and innovate

A further possible consequence of buyer power is that it may dampen the incentives of upstream buyers to invest and innovate, although there are also powerful economic arguments to the contrary[18]. The economic literature is not conclusive on this point.

The economic argument in favour of this proposition (that buyer power dampens upstream innovation) is essentially that of the classic 'hold-up' problem. If a large buyer has strong bargaining power relative to its suppliers, then it can capture a large share of any future joint surpluses arising out of its bilateral supply relationships. Suppliers, in turn, may 'respond by under-investing in innovation or production'[19] because they foresee that they will not be able to capture an adequate portion of the total return on the investment that they need to make to fulfil the supply order. Because they will not be able to capture adequate returns, they do not make the investment in the first place. This effect is said to lead, over a sector, to under-investment in productive capacity and innovation.

One contrary view is powerful buyers, rather than causing a hold-up problem, may instead be able to help overcome hold-up problems. An argument is that large buyers may have strong incentives to develop long-term relationships with suppliers and to co-sponsor investments with these long-term suppliers, and that this may in fact enhance the incentives of such suppliers to invest and innovate.

A further contrary view is that, if there are few large buyers, this may reduce transaction costs and coordination problems in upstream markets (compared to if there were many small buyers). The argument is that this may enable more efficient contracting in the supply relationship and, in particular, may enhance incentives for and prospects of long-term contracting, which would enhance the incentives for those suppliers to invest and innovate.

A final contrary argument is that the presence of a powerful buyer may also increase the incentives for suppliers to invest and innovate in that such investment may increase the ability of those sellers to sell their product through alternative buyers.[20]

Incentive to innovate—impact on product variety

If the presence of buyer power has an impact on incentives to invest and innovate, this may in turn have an impact on the breadth of product variety produced in upstream markets (and available to retail consumers downstream). A reduction in product variety is generally considered to cause a reduction (all else being equal) in consumer welfare, as it decreases the choice of products from which consumers can select.

Economic analysis has demonstrated that where a monopoly manufacturer sells a range of differentiated products through a large retailer and a number of small retailers, an increase in the buyer

17 See C C de Fontenay and J S Gans, 'Vertical integration in the presence of upstream competition', *RAND Journal of Economics*, 36(3), 2004, pp. 544–72.

18 See R Inderst, and C Wey, 'Buyer power and supplier incentives', *European Economic Review*, vol. 51, 2007, pp. 647–67.

19 See Federal Trade Commission, Report on the Federal Trade Commission workshop on slotting allowances and other marketing practices in the grocery industry, report by the Federal Trade Commission staff, Washington, DC, 2001.

20 See R Inderst and C Wey, 'Buyer power and supplier incentives', *European Economic Review*, vol. 51, 2007, pp. 647–67.

power of the large retailer can reduce the variety of products that are manufactured, thereby tending to reduce consumer welfare (all else being equal). Simultaneously this can reduce the retail price paid by consumers, thereby tending to increase consumer welfare (all else being equal).[21] The net impact on consumer welfare depends on which effect outweighs the other, and the formal modelling in question demonstrates that it is possible that the decrease in welfare from loss of product variety can outweigh the welfare enhancing impact of lower prices.

However, the formal economic analysis in this area is not conclusive, and the actual impact on product variety and consumer welfare in any set of circumstances will need to be determined in light of the empirical evidence connected with the particular circumstances.

14.5.5 Impact on other retailers

A retailer buyer with buyer power may also have an impact on other competing retailers.

Two broad issues emerge from the economic literature. Firstly, the large retailer's buyer power may affect supply prices paid by other retailers. Secondly, the large retailer's buyer power may, over time, affect retail market structure.

Impact on supply prices paid by other retailers

A large retailer with buyer power may be able to use this to obtain lower input prices than it might otherwise be able to obtain without buyer power. This effect may in turn affect input prices that other competing retailers pay for their inputs. But will the other retailers face increased or decreased input prices as a result of the large retailer's buyer power?

The economic literature on this subject is still quite small and not yet clear, and there is in fact a conflict in the results arising from different analytical models that have been proposed, with certain analytical models proposing the result that other retailers pay lower input prices because of the large retailer's buyer power. Other models propose the opposite result—that other retailers pay higher input prices.

In a simple textbook monopsony power framework, the result appears quite clear that other retailers will also pay lower input prices. In this framework, buyers and sellers interact in the context of a single wholesale market, and the input is traded at a single wholesale price. The large buyer can obtain a lower input price by withholding demand. The other retailers also pay the same wholesale price for the input, so that the other retailers benefit from the same decreased input price.

However, as discussed in section 14.3 and appendix I, the monopsony power framework is unlikely to be the appropriate framework for analysis of buyer power in most retail input markets. The clear results from this simple framework cannot be relied upon to any significant extent.

Some papers within the bilateral bargaining literature (which is likely to be more appropriate for analysing grocery supply markets—see section 14.3 and appendix I) similarly conclude the smaller competitive fringe retailers will benefit from a lower supply price in a bargaining framework. One recent paper shows that, where there is an increase in the bargaining power of a single large retailer, upstream suppliers may find it strategically optimal to also set a lower wholesale price for the competitive fringe.[22] Another recent paper shows that if large retailers with buyer power compete more aggressively in downstream retail markets in consequence of obtaining a lower input price, then this may reduce the downstream demand for products on sale by the smaller retailers, which will in turn reduce their

21 See Z Chen, 'Countervailing power and product diversity', mimeo, http://ideas.repec.org/p/ecm/nawm04/279.html; and P Battigalli, C Fumagalli and M Polo, 'Buyer power and quality improvement', CEPR discussion papers 5814, CEPR. discussion papers, 2007.

22 See Z Chen, 'Dominant retailers and the countervailing power hypothesis', *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25.

upstream demand for inputs, which may in turn lead to the smaller retailers also paying a lower retail price.[23]

Another group of papers, however, concludes that a large retailer's buyer power will instead force up the input prices paid by other competing retailers. Among these is a subgroup of papers that argues for the existence of a supposed 'waterbed effect', which pushes up the price paid by other retailers. Under this proposed waterbed effect, an increase in buyer power that lowers the large buyer's input price would lead suppliers to seek to recover lost profits by charging higher prices to other buyers that do not have the same level of bargaining power.

A typical explanation for this is a cost shifting narrative. This explanation relies on suppliers incurring certain fixed costs. If the suppliers recover fewer of these fixed costs from the large buyer (which forced their input price down by bargaining power) or none of them if the powerful buyer negotiates to pay marginal costs, according to the argument the suppliers must recover more of these fixed costs from other buyers. It is argued that the suppliers must shift more or all of their fixed costs onto smaller/weaker buyers, thereby increasing the total price paid by those weaker buyers.[24]

Another mechanism by which, it is argued, this effect may occur is through a change in the upstream market structure. In this explanation, if suppliers' profits are eroded by a powerful buyer negotiating lower input prices, this may induce smaller or weaker suppliers to merge or exit the industry. This in turn may weaken the bargaining power of the weaker buyers, as their best outside option bargaining positions deteriorate if there are fewer potential suppliers. This weaker bargaining position then leads to them having to accept higher input prices.

This proposed waterbed effect has had a certain influence in the thinking of competition authorities. For example, the UK Competition Commission has considered that such an effect might occur in the private healthcare market as a result of a merger in that industry[25], and it has stated in the context of investigating prospective supermarket mergers that:

> The exercise of buyer power by the merged entity would have adverse effects on other, smaller, grocery retailers through the 'waterbed' effect—that is, suppliers having to charge more to smaller customers if large retailers force through price reductions which would otherwise leave suppliers insufficiently profitable …[26]

But the existence (and if it exists, the relative importance) of such a waterbed effect is far from universally accepted. A common objection is that this sort of cost-shifting violates standard axioms of profit maximisation—if the supplier is able to charge higher prices of the smaller retailers after the decrease in price charged of the powerful buyer, why didn't they do so before? A second objection is that a number of the influential economic models of buyer power predict the opposite result—that is, that a decrease in the price paid by the powerful buyer will result in the smaller competing buyers also paying a reduced price.[27]

Further, even if a waterbed type effect exists and results in weaker retailers paying higher input prices, it is far from clear from the economic modelling what the impact will be on downstream prices. This second question is a separate—even if related—question, the answer to which will depend partly on the state of competition in the downstream retail sector.

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23 See S P King, 'Does buyer power benefit outsiders?', mimeo, 2008.

24 See, for example, A Majumdar, 'Waterbed effects and buyer mergers', CCP working paper 05–7, University of East Anglia, 2005.

25 Competition Commission, Supermarkets: a report on the supply of groceries from multiple stores in the United Kingdom, Cm 4842, HMSO, 2000, p. 2.180b.

26 Competition Commission, Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc, Cm5950, HMSO, 2003, p. 2.218.

27 See, for example, Z Chen, 'Dominant retailers and the countervailing power hypothesis", *Rand Journal of Economics*, vol. 34, 2003, pp. 612–25; and S P King, 'Does buyer power benefit outsiders?', mimeo, 2008.

However, competitive harm to other buyers/retailers as a result of a powerful retailer's buyer power can also occur through other channels that do not require the existence of a waterbed effect.

One possible effect is where a powerful buyer also has a 'first mover advantage' in retailing—that is, it establishes itself in the retail sector before its competitors. Economic models analysing this situation have concluded that such a first mover advantage in retail supply markets can benefit the powerful buyer while leaving other buyers worse off.[28]

Others have proposed that aggressive loss-leader pricing by large retailers can inflict competitive damage on smaller, weaker retailers. However, there are also counter arguments that dispute the extent or existence of such effects.

Because of the lack of clarity and conclusiveness in the economic literature on this issue, the actual impact on other retailers of a large retailer's buyer power will need to be assessed on the basis of the particular factual evidence.

There is some empirical evidence that larger buyers tend to pay lower upstream input prices than smaller retail buyers.[29] However, lower upstream prices paid by a large retailer do not in and of themselves necessarily mean that these prices are lower because the large buyer is exercising some degree of undue buyer power. Variations in price can also reflect genuine cost differences. It may, for example, be that there are economies in supplying larger orders for larger retailers. Further, a large chain may also be able to generate efficiencies through, for example, more efficient supply and purchasing strategies. Thus lower input prices do not necessarily lead to the conclusion that there is a market power or anti-competitive reason for these cost differences. If there are cost differences, it is a matter for an inquiry to decide, on the basis of the evidence, the reasons for the differential.

Impact over time on retail market structure

The second issue regarding the impact on other retailers is the effect that buyer power may have over time on retail market structures.

A powerful buyer may be able to obtain lower input prices from suppliers, which may in turn be passed on, fully or partially, to retail consumers in the form of lower retail prices.

According to one school of argument, this may give rise to virtuous circles, whereby the lower price retailers expand their sales further, thus enabling them to obtain even lower input prices from suppliers, which will be passed on to consumers in the form of even lower retail prices, and so forth, to the consumer's expanding benefit in the form of retail prices that are continually and progressively ratcheted down.

The common counter-argument to this point of view is what might be termed the vicious circle proposition. According to this view, virtuous circles of continuingly decreasing retail prices rely crucially on the assumption that smaller/weaker retailers will not exit the retail market. According to this argument, this is an unrealistic assumption, as ever-decreasing prices will progressively push out retailers, starting with the weakest—for example, those with the lowest retail margins. Following this argument further, as weaker retailers are progressively pushed from the market, the remaining retailers will benefit from a corresponding increase in downstream market concentration and decrease in competition, which may lead to higher prices in the long run and even progressively increasing prices if

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28 See, for example, F Mathewson and R Winter, 'Buyer groups', *International Journal of Industrial Organization*, vol. 15, 1996, pp. 137–64; J S Gans and S P King, 'Exclusionary contracts and competition with large buyers', *International Journal of Industrial Organization*, vol. 20, 2002, pp. 1363–81.

29 Competition Commission, The supply of groceries in the UK market investigation, 2008, paras 5.19–5.43.

weaker retailers are pushed out of the market (the proposed vicious circle).[30]

There are, however, counter-objections to such vicious circle arguments. Firstly, it is argued that such models do not account for competition that could arise from other sources (for example, from entry), or from expansion by an existing smaller player to occupy a market position characterised by greater product differentiation.

The economic literature is, as with other relevant branches of the economic literature, conflicted and uncertain in its conclusions on this. The longer term impact of buyer power on retail market structures will need to be determined based on the empirical evidence arising out of the relevant retail market.

14.6 Cases on buyer power under section 46 of the Trade Practices Act

14.6.1 ACCC v Safeway

In 2001 the ACCC began proceedings against Australian Safeway Stores Pty Ltd (Safeway)[31], a member of the Woolworths Limited Group, for breaches of ss. 45(2)(a)(ii), 46, 47 and 48 of the Trade Practices Act.

The ACCC alleged Safeway had a policy that, if bread products of a manufacturer were being sold on special by another retailer (other than Coles or Franklins) in the vicinity of a Safeway store at a price under what was being charged at the Safeway store, all the manufacturer's bread products would be removed from sale at that Safeway store and other nearby Safeway stores until the retailer ceased selling the manufacturer's products at the special price.

The ACCC also alleged that Safeway's conduct attempted to punish bread manufacturers Tip Top, Sunicrust and Buttercup for selling bread to independent stores at prices that enabled them to retail at less than the prices at which Safeway was selling the bread. Further, the ACCC alleged that by the implementation of the so-called 'deleting' policy—that is, ceasing to stock, display or sell the bread product—the bread manufacturers were discouraged from both supplying bread to retailers at prices which enabled them to discount the bread and from supplying bread to retailers that were likely to sell the bread at prices cheaper than Safeway.

Safeway denied it had such a policy and instead argued its conduct was pro-competitive rather than punitive. Safeway said it would ask the bread manufacturer for a 'case deal'. This involved requesting a cost price equal to that of Safeway's competitors, allowing Safeway to sell its bread at a similar price to its competitors who were offering the discounted price. Safeway argued that the bread manufacturers had refused the case deal and that these deletions were a result of their refusal. However, evidence during the trial showed that these case deals were only sought in five of the nine instances of product deletion.

The case was heard in the first instance by Justice Goldberg who held that the alleged contraventions of ss. 45, 46, 47 and 48 had not been made out. In relation to s. 46, Justice Goldberg found that Safeway had a substantial degree of market power in the wholesale market for the acquisition of bread but had not taken advantage of that market power because there was no connection between their market power and the relevant conduct.[32]

30 See, for example, R Inderst, 'Leveraging buyer power', *International Journal of Industrial Organization*, vol. 25, 2007, pp. 908–24.

31 Australian Competition and Consumer Commission v Australian Safeway Stores Pty Ltd (N. 3) (2001) 119 FCR 1.

32 ACCC v Australian Safeway Stores Pty Ltd (No 3) (2001) 119 FCR 1, 258.

> The reality of a competitive wholesale market in which Safeway did not have substantial market power would be that Safeway would still have alternative sources of supply available if a plant baker refused to stop selling bread to an independent store and Safeway stopped buying that plant baker's bread.[33]

On appeal in 2003, the Full Federal Court found that four agreements entered into by Woolworths with liquor license applicants contravened s 45 of the Act. The court found that Goldberg J had erred in finding that Safeway had not taken advantage of its substantial market power.[34] Heerey and Sackville JJ, in their joint decision, held there would have been no purpose or benefit for Safeway to delete the bread products from its stocks in a competitive market and applied the decision in *Melway*[35] in determining that:

> Safeway's conduct in the four instances was therefore *materially facilitated* by the existence of its market power even though that same conduct would not have been 'absolutely impossible' without that power.[36] [Emphasis added.]

Special leave to appeal to the High Court was refused in 2004.[37] On 31 January 2006, on reversion from the Full Federal Court, Goldberg J imposed on Safeway a penalty of $8.9 million.

14.7 Conclusions

This inquiry broadly prefers a bilateral bargaining power model as the appropriate analytical framework to analyse buyer power in the grocery retail industry, in preference to a monopsony power framework. This is because the bilateral bargaining model more closely fits the actual structural features of grocery supply markets (a series of bilateral relationships, rather than wholesale markets), and better predicts empirical outcomes of grocery retail supply (decreases in price often not accompanied by decreases in quantity).

Buyer power may have an impact on any or all of consumer welfare, other competing retailers, and suppliers to the buyer, as outlined in this chapter. There may also be an impact on related aspects such as supplier market structures, and product variety, as discussed above in this chapter.

However, the formal economic theory of buyer power (especially in relation to bilateral bargaining power) is still developing, and the exact nature of the impact of buyer power is in some respects still not clear from formal economics. For instance, it is not clear a priori what will be the impact of buyer power on downstream retail customers. Retailers may pass on upstream savings due to buyer power, thereby benefiting consumers, or they may not. Buyer power can not be said to be per se either enhancing or destructive of downstream competition or final consumer welfare. Similarly, buyer power that reduces a large retailer's input prices may also result in decreased input prices for other retailers, or it may result in increased prices to competing retailers (e.g. by way of a waterbed effect). In consequence, judgments regarding the impact of buyer power in the hands of large retailers must still remain (to some extent at least) an empirical judgement based on the evidence arising out of specific factual situations.

The evidence that has been presented to this inquiry about buyer power is considered in the next chapter.

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33 ACCC v Australian Safeway Stores Pty Ltd (No. 3) (2001) 119 FCR 1, 259.

34 Australian Competition and Consumer Commission (ACCC) v Australian Safeway Stores Pty Ltd (2003) 129 FCR 339.

35 Melway Publishing Pty Ltd v Robert Hicks Pty Ltd t/as Auto Fashions Australia (2001) 205 CLR 1, 23.

36 ACCC v Australian Safeway Stores Pty Ltd (2003) 129 FCR 339, 409.

37 Both Safeway and the ACCC made applications seeking special leave to appeal to the High Court of Australia on various aspects of the Full Court decision. Safeway sought to appeal against the findings of ss. 45 and 46, and the ACCC sought to appeal the finding that Safeway had not misused its market power in five of the nine instances alleged.

15 Evidence of buyer power

Key points

- The major supermarket chains (MSCs) and Metcash have significant buyer power in packaged groceries because suppliers of packaged groceries effectively have little option other than to deal with those companies.
- Suppliers of key brands of packaged groceries have countervailing power in relation to those brands. However, this countervailing power is generally not sufficient to offset buyer power across the supplier's entire range.
- The greater number of options available to sellers of fresh produce and meat—which include export, food service and sale into the wholesale markets—limit the MSCs' buyer power in relation to those products overall.
- The MSCs may be able to exercise significant buyer power in relation to a particular seller but the extent to which they are able to do so is dependent on the outside options available to that seller.

Effect of buyer power

- The inquiry was provided with little evidence to substantiate anecdotal allegations of buyer power being exercised in an anti-competitive or unconscionable manner rather than simply to drive a bargain that was harder than the supplier would have preferred. Having said that, there were some complaints of buyer power being exercised where the complainant appeared to be genuinely concerned about retribution if details were provided to the ACCC and investigated.
- In relation to fresh produce, there is no credible evidence that MSCs (or anyone else) can manipulate wholesale prices to suppress prices below competitive levels.
- Farm gate prices are determined by the supply and demand conditions prevailing in the relevant market, rather than by buyer power. In many instances, farm gate prices are heavily influenced by supply and demand in world markets.
- MSCs generally buy products on better trading terms than other buyers. This is often because of the MSCs' stronger buyer power. However, suppliers consider that the MSCs are also better able to execute agreed promotional activities and this is reflected in suppliers' willingness to offer higher discounts to the MSCs.
- There is little evidence that incentives to innovate are being impacted upon adversely by buyer power.
- Competition is not sufficiently strong at the retail level to ensure that consumers always benefit from buyer power in the form of lower retail prices.

15.1 Introduction

There is considerable community concern, particularly in relation to fresh produce, that the MSCs are able to, and do, force down the prices that they pay to suppliers below the levels that would prevail in a competitive market. Such circumstances may arise if MSCs have buyer power, the exercise of which enables the MSCs to achieve supply terms that they could not achieve in a more competitive market. Community concern is often exacerbated by the apparently large differences between the prices that suppliers receive for their produce and the retail price that consumers ultimately pay, leading to suspicions that the MSCs are exploiting not only suppliers but consumers as well. In recognition of these concerns, the ACCC has examined a number of fresh produce items in more detail. The results of these case studies were presented in chapter 12.

This chapter examines the evidence that has been presented to the grocery inquiry that may indicate the presence of buyer power. This evidence is evaluated using the framework that was set out in chapter 14.

Community concerns about buyer power are reflected in anecdotal claims that MSCs' buyer power is having a detrimental impact on sellers. Concerns were also raised that fear of buyers' retribution is preventing those sellers from coming forward and substantiating those claims. For instance, the National Association of Retail Grocers of Australia (NARGA) submitted:

> Consider the situation of a major national grocery supplier, dealing with two customers taking 45 per cent and 35 per cent of his production respectively. Unless that manufacturer is prepared to lose 45 to 35 per cent of his sales or both, his ability or willingness to resist intimidation or risk retribution from either customer is virtually non-existent. [1]

The South Australian Farmers Federation expressed the problem as follows:

> The reasons why growers won't speak out is that they are afraid of the repercussions of speaking out and they rely on the marketplace to work for them and therefore to ostracise themselves against that marketplace is in large part seen as not being in their best interests and so they come to our organisation and say, fix it. It's very difficult, however, to get individuals with anecdotal evidence to come forward under those circumstances because of the fear that surrounds it. [2]

Grow SA, Growcom and the National Farmers Federation expressed similar views.[3]

The Horticulture Australia Council, which claims to represent over 97 per cent of Australia's horticulture industry, gave an indication of the apparent magnitude of the concerns in its submission:

> A recent survey of members agreed (85%) that growers were often unwilling to raise issues with major retailers and wholesalers for fear of retribution. [4]

Despite these concerns, the Produce and Grocery Industry Code Administration Committee told the inquiry:

> From evidence that we have received from the Ombudsman there is anecdotal evidence of what you say in terms of fear of retribution but the Ombudsman has consistently reported to us that there has never been any actual evidence of that coming before the Ombudsman. Nor has there been any claim based on victimisation. [5]

Recognising that existing administrative arrangements may be inadequate to deal with suppliers' concerns, the ACCC placed a high priority in giving suppliers the opportunity to raise their concerns either publicly or in confidence during the inquiry. Every supplier who provided evidence at the inquiry's public hearings was summonsed to appear so that buyers could not draw any conclusions about a supplier's willingness to provide information to the inquiry. In addition, much of the evidence given to this inquiry by suppliers was provided on a confidential basis.

Despite this, there was very little in the way of specific evidence of harsh or unconscionable conduct by the MSCs, or specific incidents of apparent abuse of their market position by the MSCs. In fact, many

1 NARGA, submission no. 129, p. 2.

2 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 4.

3 See Grow SA, submission no. 112; Growcom, submission no. 6; ACCC, public hearing transcript, Canberra, 30 April 2008, p. 5.

4 Horticulture Australia Council, submission no. 63, p. 5.

5 ACCC, public hearing transcript, Melbourne, 30 May 2008, p. 6.

growers and suppliers summonsed to attend the hearings by the ACCC provided positive reports about the conduct of the MSCs, which would not normally be brought to the public's attention.

15.1.1 General comments on buyer power from evidence

The evidence presented to this inquiry on buyer power focussed on the MSCs and Metcash, with most emphasis on the MSCs. Much of this evidence was conflicting.

On the one hand, suppliers generally consider that the MSCs and Metcash have buyer power.

For example, the Australian Food and Grocery Council (AFGC), which represents 150 companies in the packaged food, drink and grocery products industry, submitted:

> Undoubtedly the market power of the retailers and wholesalers has increased, in a market among the most concentrated in the world. As a result, there is substantial and increasing buying power of retailers and wholesalers in the Australian grocery sector.[6]

Commenting directly about Woolworths' buyer power, the AFGC continued:

> Woolworths' move into the New Zealand market has increased its buying power for goods from suppliers who service both markets from Australia.[7]

The Australian Beef Association (ABA) submitted:

> The supermarket duopsony has used its buying power to pressure wholesaler/processors to lower their prices and in-turn processors have used their relative market power to lower the price of livestock [beef]…While the supermarket duopsony is allowed to exercise unrestrained market power, Australian farmers will not be able to negotiate prices that reflect the cost of production.[8]

The Australian Honey Bee Industry Council's (AHBIC) views are similar to those of the AFGC and the ABA:

> The AHBIC submits that through a variety of mechanisms the effective duopsony in Australian markets for the supply of inputs to the wholesale and retail levels of the grocery industry has been able to secure and exercise buyer power against suppliers. The effect of the exercise of buyer power by the MSCs against honey product suppliers has been to transfer rents, in this case quasi-rents, from honey product suppliers to the MSCs.[9]

George Weston Foods (GWF) provided a specific example of buyer power in the small goods industry:

> The strong countervailing power of the MSCs is well documented. In the context of the smallgoods industry, the IBIS World Risk Report noted:
>
> One of the biggest threats facing the profitability of the industry is the ongoing consolidation of the industry's retail foods client base. The continuing reduction in the number of retail buyers, the growth of giant supermarket chains and the use of category management practices is weakening the negotiating strength of the industry's players in supply contracts. The uptake of global supply strategies by the large supermarkets has also been one of the most significant issues facing the Australian Bacon, Ham and Smallgoods manufacturers.[10]

Another supplier told the inquiry confidentially:

> I feel there's a lot of power at the buyer level. There's no doubt that I've never struck a national sales manager that hasn't basically lived in fear of what the buyer might do.

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6 Australian Food and Grocery Council, submission no. 73, p. 2.

7 Australian Food and Grocery Council, submission no. 73, p. 6.

8 ABA, submission no. 146, p. 6.

9 Australian Honey Bee Industry Council, submission no. 59, p. 10.

10 George Weston Foods, submission no. 138, p. 8.

Metcash implied that it does not have buyer power but that the MSCs do. Metcash submitted:

> In general, Metcash is viewed as a 'third force' that dilutes the bargaining power of the major chains and strengthens the bargaining position of suppliers in the market.[11]

Woolworths agreed that its trading terms with suppliers reflect its strong bargaining power.[12] However, Coles submitted that suppliers often have countervailing power that offsets any buyer power it may otherwise have:

> Many of Coles suppliers are large international companies with significant countervailing power and in many cases have far greater financial power than Coles–Australia is a relatively small market–they do not need to sell in Australia if the returns are not acceptable.[13]

GWF disagreed with Coles' view, submitting:

> Any market power that a supplier has is significantly diminished by the countervailing power of the MSCs who effectively control the process. A supplier is not in a position to charge more or provide less as the consequences of such a challenge to the MSCs would be profoundly detrimental. [14]

Some of the evidence discussed above, such as that from the AFGC and GWF, suggests that retail buying power is increasing over time to the detriment of suppliers. In addition, the inquiry heard confidential evidence from a supplier that Woolworths' negotiating position is becoming stronger as its market share increases, and that suppliers had more bargaining power prior to the sale of Franklins in 2001. In contrast, another supplier told the inquiry in confidence:

> The MSCs are hard negotiators–they're very professional in their business dealings. But I wouldn't say it's gotten worse, and nor would I say it's unduly hard.

Along similar lines, Coles explained:

> The relationship with suppliers is premised on the need to ensure an ongoing supply of quality products that meet consumers' needs and preferences. To achieve this, the supplier relationship must be open, fair and ensure a reasonable, mutually beneficial return. While it is not unusual for there to be some commercial tension in negotiations between suppliers and resellers, it is not in Coles' long term commercial interest to undermine these relationships by setting out to achieve one-sided outcomes. The vast majority of Coles' suppliers continue to value the relationship – some have been suppliers to Coles for more than 20 years.[15]

As outlined above, the evidence to the Inquiry as to the extent of the MSCs' buyer power and whether it is increasing, was varied. The following sections explore in more detail specific evidence that has assisted the ACCC form its views about the existence or otherwise of buyer power, and its consequent effect on competition and consumers.

15.2 Outside options

As explained in chapter 14, the outside options concept is critical to an assessment of buyer power in a bilateral bargaining context. A buyer's or seller's outside option(s) is simply the best outcome that either could achieve by walking away from negotiations relating to the supply of a product from the seller to the buyer. The extent of a buyer's power in any given transaction will depend crucially on the quality of the seller's outside option(s).

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11 Metcash, submission no. 217, p. 7.

12 ACCC, public hearing transcript, Melbourne, 19 May 2008, pp. 32–33.

13 Coles, submission no. 225, p. 32.

14 George Weston Foods, submission no. 138, p. 12.

15 Coles, submission no. 157, p. 5.

Supply to other domestic or overseas retailers may be a viable outside option for some suppliers. For suppliers of fresh produce and meat it is clear that in the short or medium term a number of outside options are available. These include export, the wholesale markets, food service and food manufacturing.[16]

The inquiry has heard evidence that the outside options available to suppliers of packaged groceries are generally more limited than those available to suppliers of fresh produce. Hence this section will consider the outside options available to buyers and sellers in each of those sectors in turn.

15.2.1 Packaged groceries—sellers' outside options

In the context of the supply of packaged groceries, a seller may have a range of outside options, including export to overseas customers, supply to other retailers or supply through other distribution channels such as food trade or direct supply to customers.

Limited evidence was provided to the inquiry about the potential for suppliers to supply directly to customers or through other distribution channels.

The ACCC is aware that some suppliers of packaged groceries currently export to overseas countries. Generally, however, export sales are a small share of revenue and it is not clear whether export volumes could be expanded rapidly to replace volumes lost by walking away from a large retail grocery buyer. Nevertheless, the inquiry heard confidential evidence from a supplier that is pursuing export markets in response to its perceptions of domestic retail buyer power.

Therefore, as the inquiry has been told, for many suppliers of packaged groceries, supply to other retailers remains the main outside option available.[17] The inquiry has heard evidence that supermarkets account for the vast majority of purchases of packaged groceries such as biscuits, snacks and soft drinks.[18] In this regard, the evidence indicates that many suppliers of packaged groceries cannot afford to walk away from negotiations with Woolworths or Coles as their outside options to sell their products are limited.

For instance, suppliers have suggested in confidential evidence to the inquiry that they do not have the option of walking away from negotiations with the MSCs because the MSCs typically account for such a large share of the supplier's sales that those lost volumes could not be made up entirely by placing the product in alternative distribution channels, particularly in the short run. A supplier told the inquiry in confidence that it could not afford to lose 100 per cent of its business with one of the MSCs because it would take time to replace the lost volume with increased sales through other retailers. Suppliers told the inquiry that a decision to walk away from an MSC would have a substantial impact on a supplier's operating profit, not only because of lost volumes but also because of the lost promotional opportunities that a relationship with an MSC provides.

The ACCC considers that for most suppliers of packaged groceries the outside options available are largely restricted to supply to other grocery retailers.

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16 See, for example, ACCC, public hearing transcript, Perth, 22 April 2008; ACCC, public hearing transcript, Canberra, 8 April 2008; ACCC, public hearing transcript, Canberra, 9 April 2008; ACCC, public hearing transcript, Brisbane, 3 April 2008; George Weston Foods, submission no. 138; and ACCC, public hearing transcript, Port Lincoln, 29 April 2008, p. 4.

17 Metcash, submission no. 181, p. 12.

18 Metcash, submission no. 181, p. 25, quoting ACNeilsen Shopper Trends, 2008.

15.2.2 Fresh produce—sellers' outside options

The evidence presented to the inquiry suggests suppliers of fresh produce, such as meat and fruit and vegetables, generally have more valuable outside options than most suppliers of packaged grocery products. In these cases, buyer power may be weaker.

For some suppliers of fresh produce, the outside option of supplying export markets rather than domestic retail markets is likely to be a viable alternative that enhances the seller's negotiating position. For instance, Coles told the inquiry:

> Some locally sourced product, such as beef, are produced for export as well as domestic consumption. Coles is faced with an additional constraint in respect of these products as suppliers can choose to export a greater proportion of their production if they are unhappy with the terms of supply requested by domestic retailers.[19]

However, the ACCC understands that for some fresh produce, such as bananas and bread, there are limited or no export opportunities because of the perishability of the product. [20]

Furthermore, export markets may be an imperfect substitute for domestic supply because of the lead times required to switch from domestic to export markets. In addition, substantial investment in plant and equipment to meet export quality specifications may be required.

The view that the buyer power of grocery retailers and wholesalers is generally weaker for purchases of fresh produce compared with packaged groceries is consistent with evidence from Coles, which told the inquiry:

> From Coles' perspective, we recognise that growers do have options and will increasingly develop them. While Coles considers it has good relationships with the vast majority of its suppliers, Coles recognises these options and seeks to ensure we are an attractive buyer to deal with. Coles also recognises the fact that it provides many of its smaller suppliers with greater certainty regarding retail volumes and continuity of supply than may be provided by these alternative supply options. Coles has relationships with many suppliers going back over 20 years. [21]

Fruit and vegetables

Fruit and vegetable growers often have a range of outside options other than supply to domestic retail stores. These options may include supply to food processors, or export of fresh produce overseas.

For instance, the Australian Government Department of Agriculture, Fisheries and Forestry (DAFF) has estimated that in 2007, 55 per cent of domestic production of fruit and vegetables was sold as fresh produce, 36 per cent underwent further processing (canning, juicing etc.) and 9 per cent was exported.[22] IBISWorld estimated that 40 per cent of vegetables in June 2008 and 26 per cent of apples and pears in December 2007 were processed following harvesting.[23]

Processing of fruit and vegetables predominantly consists of manufacturing fruit and vegetable juice, or canned, preserved, frozen or dried product. Fruit and vegetables are also key inputs into many products such as sauces, jams, prepared meals and snacks. Certain products, such as potatoes, often tend to be used in processing. Processors generally compete with imported processed products and they also export their products.

19 Coles, submission no. 225, p. 32.

20 George Weston Foods, submission no. 138, p. 11.

21 Coles, submission no. 225, p. 12.

22 S Spencer and M Kneebone, *FoodMap: a comparative analysis of Australian food distribution channels*, Australian Government Department of Agriculture, Fisheries and Forestry, Canberra, 2007.

23 IBISWorld industry report A0113, *Vegetable growing in Australia*, June 2008; IBISWorld industry report A0115, *Apple and pear growing in Australia*, December 2007.

There are also significant quantities of fresh fruit and vegetables which are exported. Exporters either contract directly with farmers or purchase from wholesalers in wholesale markets.

The ACCC understands that there are some restrictions on a grower's ability to switch between these distribution channels in the short term because of, amongst other things, differences in product specifications. For instance, the fruit and vegetables sold as fresh produce are generally of a higher grade than those used in processing, and they therefore demand a higher market price. Furthermore, the perishability of some produce such as bananas means that exports are not a viable alternative. Nevertheless, over time growers generally have some ability to switch from one distribution channel to another in response to profit opportunities.

Furthermore, for many types of fresh produce, direct supply to retailers is only one of several ways to get the produce to final domestic customers. This inquiry has heard that between 40 and 60 per cent of fresh fruit and vegetables are sold through the MSCs. The remaining volumes (also between 40 and 60 per cent) are sold through wholesale markets and to food service.

Consistent with these statistics, the inquiry was told that suppliers of fresh fruit and vegetables are often able to place their product on wholesale or export markets if they walk away from negotiations with Woolworths, Coles or Metcash.

Apple & Pear Australia Ltd submitted:

> Apple and pear growers/producers mostly sell to a range of buyers including through the MSCs and the wholesale markets…In the absence of direct supply through MSCs, suppliers can sell through the wholesale markets or export.[24]

Similarly, R Ceravolo and Co. agreed with the proposition put by the ACCC in public hearings that there are realistic alternatives, including supply to wholesale markets, to supplying directly to Coles.[25]

In response to a question from the ACCC at a public hearing about viable alternatives if the MSCs reduced their demand, the Costa Group responded:

> Yes, Aldi are a very big customer now, and, you know, the independents are certainly, collectively, are very large, and there is a number of large retailers out there. It's more a point of what business are you going to be in. I mean, we're located in growing regions; that is what our business is, but we could go and take a position in any or all of the wholesale markets at the same time, and have closer access to the independent retailers that are around the country, so there are options.[26]

Meat

Meat and Livestock Australia estimates that 35 per cent of domestic production of beef in 2007 was consumed domestically with the remainder exported. However, the inquiry has heard that differences in specifications can make it difficult for producers to switch rapidly from domestic to export markets. Furthermore, there are very few exports of poultry.

As with fruit and vegetables, suppliers of meat to the domestic market have a number of alternative supply channels including retail grocery, butchers and food service. For instance, the inquiry had heard a range of estimates (from 26 to 31 per cent) of butchers' share of domestic fresh meat sales. DAFF estimates that butchers' share of poultry is lower, at around 18 per cent.

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24 Apple & Pear Australia Ltd, submission no. 80.

25 R Ceravolo and Co., public hearing transcript, Adelaide, 28 April 2008, p. 62.

26 Costa Group, public hearing transcript, Melbourne, 15 May 2008, p. 50.

Milk and eggs

Based on the 'milk equivalents' measure produced by Dairy Australia, exports of Australian milk have been growing steadily—up from around 30 per cent of annual milk production in 1990-91 to around 50 per cent of annual milk production in 2006-07.[27] Of the domestic milk supply, around 45 per cent is estimated to be supplied to the food service sector and for industrial purposes with the remainder being used to produce retail products such as fresh milk, cheese and dairy spreads.[28]

Food service also accounts for around half of total egg supply.

Sellers' views of relationship with MSCs

The ACCC considers that suppliers of fresh produce have a range of outside options other than supply through an MSC. Consequently, the ACCC considers it would generally be easier for a supplier of fresh produce to walk away from negotiations with an MSC in response to an attempted exercise of buyer power than a supplier of dry grocery products.

Despite this, when asked at the public hearing why it did not deal with Woolworths, R Ceravolo and Co., which had been a supplier to Coles for around 40 years, responded:

> I suppose we've started with Coles so many years ago and we've been always loyal with them and I think they've tried to be as loyal as they can back with us. [29]

Similarly, while recognising its outside options, the Costa Group, which supplies mainly to the MSCs, told the inquiry:

> We're pretty comfortable with where we're at at the moment. [30]

Australian Pork Ltd submitted more generally that producers have a tendency to blame the MSCs for low producer prices; however, a relationship with an MSC can help growers achieve efficiencies:

> Pork producers have long complained that their prices are low and have in part attributed this to supermarket dominance. The arguments, however, cannot be viewed so simplistically since grocery pricing is complex and factors such as producer risk management strategies, supply chain engagement, industry structure, drought and international developments all play a part and are interdependent.
>
> Certainly over time the engagement by national retailers with sole producers, producer groups and vertically integrated producers have provided efficiency improvements in supply chain management, with some corresponding effect on quality and price.[31]

Overall, the ACCC considers that the evidence presented to the inquiry, including the lack of substantiating evidence of any abuse of buyer power, does not support assertions that the MSCs conduct in their relationships with suppliers of fresh produce is oppressive.

15.2.3 Buyers' outside options

Buyers may also have a range of outside options, such as obtaining the product from other suppliers, including imports. The ACCC considers that the value of these options is likely to vary from product to product and will depend in part on the strength of the product's brand and the extent of product differentiation. The inquiry has heard confidential evidence that there are a number of 'must have'

27 Based on the milk equivalents measure produced by Dairy Australia. This measure looks at the milk content of all exported dairy products (e.g. butter, cheese, milk powder) as a percentage of total domestic milk production.

28 S Spencer, and M Kneebone, *FoodMap: a comparative analysis of Australian food distribution channels*, DAFF, Canberra, 2007.

29 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 62.

30 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 50.

31 Australian Pork Ltd, submission no. 147, p. 3.

products that consumers expect to find on supermarket shelves that have very high levels of brand loyalty. The ACCC considers that suppliers of those brands are likely to have significant bargaining power, at least in relation to those products. Furthermore, for those brands, the value of the buyer's outside option is likely to be relatively low. A supplier told the inquiry in confidence:

> ... there's definitely differences. So in some products we would have lesser brands that we would be struggling to hold in range. But then, conversely we have very strong brands as well. So it's a balancing act.

The ACCC considers that suppliers of key brands will have countervailing power in relation to those brands. However, the evidence presented to this inquiry indicates that this countervailing power does not extend across the supplier's entire range of products and brands. As sales of that 'must have' brand or product will generally only be a portion of the supplier's total sales, the buyer is likely to retain the balance of negotiating strength.

Buyers' outside options in relation to sourcing of generic and private label products are likely to be high, except in the limited circumstances where there is only one possible supplier of the product. This is because consumers typically do not know who the manufacturer of a generic or private label product is. This makes it relatively easy for the buyer to switch sellers without consumers being aware of the change, providing quality specifications do not change. Thus the buyer could credibly threaten to walk away from negotiations if the supplier does not offer more favourable terms.

This is consistent with the view expressed by a supplier in confidence on the supply of generics:

> Given the size and importance of the chain store channel, even the threat of these chains re-tendering their supply arrangements is often sufficient to ensure that their price and delivery demands are met.

Imports

Horticulture Australia Ltd (HAL) submitted that imports of fresh fruit and vegetables represent between three and four per cent of industry value.[32] The main fruit products that are imported include avocados, kiwifruit, oranges, cherries and grapes. The main vegetables are garlic, capsicum, asparagus, onions, tomatoes, peas, mushrooms and beans.[33] HAL expects that this figure may increase as remaining trade barriers, other than quarantine restrictions, are removed.[34]

HAL submitted that imports of fresh fruit and vegetables typically occur when:

- the product is not available in Australia
- the product is available in Australia but not in the required volumes
- the price of the domestic product is higher than consumers are willing to pay.[35]

Coles submitted that Australia's quarantine restrictions place limits on the extent to which imports can be considered a viable outside option to domestic supply:

> Over 95% of fresh items need to be sourced locally for quality, freshness and quarantine reasons. This limits Coles' options with respect to sourcing those items from overseas suppliers and means we must deal with local suppliers. But those local suppliers may be able to sell internationally to countries which do not have corresponding quarantine requirements. [36]

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32 Horticulture Australia Ltd, submission no. 92, p. 103.

33 Horticulture Australia Ltd submission no 92, p. 102.

34 ibid., pp. 103-104.

35 ibid., p. 103.

36 Coles, submission no. 225, p. 32.

Imports are often a viable alternative to domestic supply of certain packaged groceries, particularly for private label and generics, and thus may enable the buyer to credibly threaten to import if a deal cannot be reached with a supplier.

GWF told the inquiry:

> The uptake of global supply strategies by the MSCs has been one of the most significant issues facing suppliers. Whether a retailer is in a position to threaten import of products in preference to local brands largely depends on the product in question. Bread, for example, because of its short shelf life is not subject to these sorts of threats. Similarly, despite relaxation of historical quarantine restrictions, the quantities of imported smallgoods products are still very small. Generally, however, retailers are able to and do source products worldwide. [37]

Further, the Apple and Pear Association of Australia told the inquiry in response to a question about whether imports have lead to a change in bargaining:

> ..the development of offshore processors, the Chinese and the South Africans, especially the South Africans, the Chileans and the Argentineans and so forth, where they've been able to leverage off the home brand shift through major retailers especially, and that created-there is no question they've created a lot of hardship for processors and suppliers in this country for the home market. There is no doubt about that. [38]

Overall, however, domestic suppliers of branded packaged groceries did not raise actual or potential import competition as a major concern for them in relation to their negotiations with domestic grocery retailers.

15.3 Retailers' absolute size

As explained in chapter 14, it is often the case that the larger the buyer in absolute terms, the greater will be its bargaining power. This could be because the value of the company's outside options increases with company size as a large company has more viable alternative sources of supply than a smaller retailer. If so, the large companies' ability to credibly threaten to withdraw from supply negotiations, including by threatening backwards integration into private labels, would be enhanced. Alternatively, a larger company may be more able to credibly threaten to sponsor the entry of new alternative suppliers than a smaller buyer.

Woolworths, Coles and Metcash are each large companies in absolute terms. NARGA told the inquiry that, in this regard, Woolworths and Coles are among the top 30 retailers in the world.[39] Furthermore, each of those 30 companies is large in relative terms. These factors are consistent with each of these buyers having a degree of buyer power.

In relation to agricultural producers, the AHBIC submitted:

> As the retail market share of the MSCs has increased, agricultural producers have become more heavily dependent on trading with the MSCs for their livelihoods. This dependence has provided the MSCs with significant bargaining power over agricultural producers which in turn has enabled the MSCs to set the terms and conditions of trade heavily in their favour. This situation has been exacerbated because not only are MSCs customers of individual agricultural producers but they are also their competitors and suppliers. The MSCs are the customers of agricultural producers in

37 George Weston Foods, submission no. 138, pp. 9–10.

38 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 14.

39 NARGA, submission no. 129, p. 1.

that they purchase their products for resale for final end consumers. Due to the large retail market share enjoyed by the MSCs in grocery retailing, an agricultural producer is readily compelled to do business with MSCs as there is little prospect of making up for lost sales elsewhere due to the highly concentrated nature of Australia's grocery industry at the wholesale and retail levels. This provides the MSCs with enormous bargaining power not just against agricultural producers but against all grocery product suppliers. [40]

Nevertheless, Coles contended that it often negotiates with suppliers who have a degree of seller power:

> While Coles has thousands of suppliers, the number of major food processors, across key food categories such as dairy, meat and grocery, consists of a small number of large suppliers. The most popular consumer grocery brands, which make up the bulk of packaged food and groceries in supermarkets, continues to be led by a small number of international food processors and manufacturers. They are often larger than Coles or command substantial market share in the food categories they supply Coles and its competitors.[41]

Metcash agreed, submitting:

> There is some evidence to suggest that the market for suppliers is relatively concentrated. The 20 largest food and soft drink manufacturers in Australia account for almost 50% of total industry turnover. In some product categories, the largest two suppliers own or share over 50% of the market. [42]

Coles suggested that its buyer power enables it to extract lower prices from powerful sellers, to the benefit of consumers:

> There's no doubt some competitive tension in there, we don't apologise for that. We're dealing with some of the largest FMCG companies in the world so we don't apologise for extracting a better price for our customers. [43]

15.4 Relative dependency on the relationship

Buyer power is more likely to arise if the relationship is of substantial financial importance to the seller but of lesser importance to the buyer. This is because there is likely to be an asymmetry in the consequences of either party walking away from the negotiations. If the buyer walks away, the consequences for the seller would be significant whereas the consequences for the buyer of the seller walking away would be less significant. Secondly, as the financial consequences for the buyer of walking away from the negotiations are not significant, any threat by the buyer to walk away would be credible. The interrelationship of these two factors would generally increase the buyer's bargaining power.

As noted above, a buyer's or seller's ability to walk away from negotiations depends to a large extent on each party's outside options. To reiterate, the ACCC considers that most suppliers of packaged groceries have little option other than to reach an agreement for supply to the MSCs and Metcash. In contrast, most suppliers of fresh produce have a range of outside options that might reduce their relative dependence on the relationship with an MSC.

40 Australian Honey Bee Industry Council, submission no. 59, p. 8.

41 Coles, submission no. 157, p. 12.

42 Metcash, submission no. 181, p. 51.

43 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 59.

Nevertheless, in relation to the relative financial importance of the relationship to sellers and buyers, the evidence presented to this inquiry indicates that most suppliers are relatively more dependent on buyers than buyers are on individual sellers. For instance, the AFGC submitted:

> For most AFGC member companies, sales of packaged food and grocery products to grocery wholesalers and retailers account for the majority of their sales[44]
>
> and
>
> Suppliers seeking to have competitive economies of scale must have a business relationship with all major retailers and wholesalers.[45]

The AFGC's submission was supported by confidential information obtained by the ACCC from suppliers of packaged groceries.

Similarly, the Queensland Citrus Growers told the inquiry:

> MSCs can clearly negotiate a better deal with suppliers than their competitors. In particular, they are able to pay less and demand more from a supplier on the basis that the wholesaler may be reliant on the MSC for a substantial proportion of his business across a range of products. [46]

Assisting this view, Coles submitted in confidence:

> '… over 50 per cent of its SKUs on the shelf are sourced from small suppliers, who are those suppliers with total sales of less than approximately $10m/pa (where total sales is [sic] sales of all of the supplier's products in Coles stores).' Many of these products are vital to Coles providing a range of product to its customers in varying price categories. [47]

The ACCC notes Coles' submission. However, while it may be the case that, in aggregate, Coles is relatively dependent on its small suppliers, the ACCC considers it unlikely that Coles is relatively more dependent on the relationship with **individual** small suppliers than the small suppliers themselves are. Furthermore, even though some of these suppliers are large in absolute and relative terms in relation to the domestic retailers, the ACCC's consideration of outside options suggests that even large suppliers are likely to be relatively more dependent on the buyer-seller relationship than are retailers.

15.5 Retailers' gatekeeper role

Retailers have a gatekeeper role between suppliers and final customers as a result of their ability to control access to supermarket shelves, dictate product placement on those shelves and set retail prices. Supermarket shelf space is a valuable and finite resource in the grocery retailing industry. Decisions regarding the allocation of shelf space and the planning of stores have significant implications for the viability and profitability of both suppliers and supermarkets.

A retailer's gatekeeper role may contribute to its buyer power by enabling the retailer to credibly threaten to de-list a product unless a supplier offers more favourable terms and conditions. Alternatively, a retailer may credibly threaten to not list a new product unless the supplier agrees to pay new product listing fees and other charges to keep the product on the shelf.

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44 Australian Food and Grocery Council, submission no. 73, p. 1.

45 Australian Food and Grocery Council, submission no. 73, p. 2.

46 Queensland Citrus Growers Inc., submission no. 49, p. 7.

47 Coles, confidential submission, May 2008, cited with the consent of Coles.

15.5.1 Category reviews

Given the differing structure and format of supermarket retailers in Australia, retailers' decisions vary regarding ranging, shelf space allocation and the development of plan-o-grams. Plan-o-grams are the diagrammatic illustration of where ranged products will be placed on retail shelves, the amount of space that will be allocated to each and how many faces or exposures each product will have to the aisle. Generally, the more profitable, higher margin products are placed in prime shelf space, which is the space between eye and hip level.

Woolworths and Coles are similar in their approach to ranging and the allocation of shelf space for products. For both MSCs, ranging and shelf space allocation is determined as part of the category review process.

Woolworths' categories are generally reviewed annually or biannually.[48] In some categories there are additional minor reviews, which, according to Woolworths, 'generally result in minimal or no range changes with the majority of new lines being introduced during major reviews.'[49]

According to Woolworths, category reviews provide suppliers in that category with the opportunity to put forward any new products. The performance of existing lines is also reviewed. [50] Reviews may result in the introduction of a new line, continuation of a line, deletion or the removal of a line from sale, or downgrade of a product. Deletion (or de-listing) refers to a product no longer being ranged and therefore no longer being available through the retailer, while downgrading refers to a product being given a poorer shelf space allocation or no longer being available in some stores. Ranging decisions are based, in part, on hurdle rates, which set the minimum number of units to be sold and the rate of return that the retailer expects to receive. Decisions are informed by scan data, which is collected at supermarket checkouts and processed by companies such as Aztec and ACNeilsen. The scan data provides suppliers and retailers with sales data for products sold in each category, and provides a basis for assessing whether the products are meeting category sales and margin targets.

Category captains

The inquiry was told that key suppliers in each category are sometimes invited to provide input into category reviews by sharing their knowledge of consumer behaviour and global product trends with retailers. These suppliers are known as category captains. For instance, Coles told the inquiry that, as part of its agreement with Coles, a category captain will agree to provide insights, information on global developments in the relevant category and 12 months notice of new product developments.[51]

15.5.2 Threat of de-listing

As part of category reviews, MSCs decide which new products will be listed in a category and which existing products will be deleted from the category.

Each of the retailers has a number of criteria that a product must meet in order to be placed on the retailer's shelves. These generally include sales and profit potential (including ability to meet target performance criteria).

48 See www.woolworths.com.au/resources/vguide_cds09%201.1.xls, accessed 18 June 2008.

49 ibid.

50 See www.woolworths.com.au/resources/vguide_vendorguide190508.pdf, accessed 2 July 2008.

51 Coles response to s. 95ZK Notice, cited with the consent of Coles.

If a retailer has buyer power, it may be able to credibly threaten to de-list a product unless the supplier offers more favourable terms and conditions. Furthermore, retailers may de-list an otherwise well performing product in order to make shelf space available for its own private label products.

Metcash expressed the issues as follows:

> The MSCs can credibly threaten the de-listing of products and/or ranges of suppliers either as a ranging strategy or to favour their private label brands. In a highly concentrated market, the de-listing of products by the MSCs could result in suppliers exiting the market, thus further intensifying the level of market concentration. [52]

In addition, GWF told the inquiry:

> For all of GWF's products, the threat of de-listing is certainly credible. Any such threat has to be weighed against the requirement for retailers to provide a comprehensive range which includes consumer preferred brands. While for a percentage of consumers private label products are a relevant choice, a more limited range may have the effect of driving consumers elsewhere. [53]

The inquiry was provided with little evidence that retailers misuse buyer power in relation to the deletion process. The evidence indicates that MSCs typically give suppliers advance notice of four to six weeks that a product is at risk of deletion. During that time, the supplier generally has the opportunity to try to improve the performance of the product. The supplier may attempt to improve the product's pricing by offering an additional case deal, increasing promotional activity or increasing advertising in external media.

The inquiry gathered confidential evidence from the MSCs on recent product deletions and the reasons for those deletions. In some instances, deletion was instigated by the supplier or related to the supplier's inability to meet quality requirements. However, the majority of deletions related to poor sales performance. In several cases, a deleted product was replaced by a new product from the same supplier.

The ACCC does not consider that the giving of advance notice of the potential deletion of an underperforming product necessarily represents a 'threat' that is consistent with the exercise of buyer power rather than normal business practice. Similarly, a supplier's offer to increase promotional support to a failing product in an attempt to increase sales and prevent deletion is consistent with competitive behaviour and not necessarily indicative of behaviour caused by buyer power.

A key issue, however, is the extent to which buyers accept this additional promotional support and pass it through to retail prices rather than retain it as higher margins. Generally, the ACCC is not satisfied that retail competition is sufficiently strong to ensure that consumers always benefit from any increased promotional support paid by suppliers to defend weak products from deletion.

The inquiry heard evidence that, on occasion, the MSCs attempt to recover some of the costs of product deletion, including the cost of marking down the product to clear stock from the supplier even though the ownership of the product has already passed to the MSC under previously agreed supply terms. The MSCs leverage the need for a supplier to maintain a distribution channel into a request for payments, which amounts to a unilateral variation of the supply terms. The ACCC considers that such practices are consistent with buyer power and lead to an inappropriate risk allocation in some circumstances.

52 Metcash, submission no. 181, p. 51.

53 George Weston Foods, submission no. 138, pp. 9-10.

15.5.3 Fees and charges for accessing shelf space

The MSCs enter into a range of commercial arrangements with suppliers, including payments essentially in return for gaining access to retail shelf space, particularly for new products. The ACCC has formed this view even though some retailers told the inquiry that they do not charge new product listing fees—that is, fees for new products to access retail shelf space.

FoodWorks told the inquiry that it does not charge slotting fees, but contended that the MSCs do:

> It is generally understood that unless a supplier pays the slotting fee (by whatever name that might be given) to the MSC, the products do not get on the shelf. FoodWorks does not have ranging fees.
>
> This [payment of slotting fees to MSCs] generally means the larger suppliers get 'ranged' as they have the better ability to pay. This leads to less competition at supplier level as smaller players disappear. Most retailers will seek to utilise their shelf space and gondola ends to secure a range of promotional fees from suppliers at various times through the year (eg Easter eggs) however this is different to whether the products are ranged at all. [54]

In response to FoodWorks' assertion, Coles countered:

> Contrary to some assertions, Coles does not consider that it charges slotting fees to suppliers in order for them to access shelf space (see Foodworks submission). Coles wants products sold in its stores to be successful. Given that every product stocked by Coles occupies space that could be used to stock a different product, the choice of one product over another represents an opportunity cost to Coles. Consequently Coles needs a compelling reason to stock that product generally in the form of a reasonable degree of certainty that sufficient volumes of the product will be sold. [55]

Woolworths told the inquiry:

> In relation to access to shelf space, Woolworths Supermarkets does not charge new line fees, slotting fees, 'pay to stay' fees or any other kind of fee to suppliers. All payments received from suppliers are referable to sales generating activities. [56]

Similarly, ALDI submitted:

> In dealing with suppliers, we do not charge them slotting, or any other fees, in order for them to obtain product exposure. We consider such arrangements to be inconsistent with our low cost approach and incompatible with supplying our own exclusive brand products. Ultimately the customer will carry the cost of slotting fees in the form of higher prices and they may also miss the opportunity to obtain the best value product. With slotting fees and other supplier funded promotional activity, customers are not offered the best product but the product that is able to pay for placement. [57]

Metcash told the inquiry that it does not charge slotting fees but may charge a listing fee for new products:

> Metcash as a non-vertically integrated wholesaler cannot guarantee the shelf placement of products by independent grocery retailers. Therefore, it does not charge slotting fees to suppliers. However, when Metcash negotiates the introduction of new products with a supplier, it may charge a listing fee and negotiate some form of support for this product – either through introductory promotions and/or other allowances – in the first 6 – 12 months after new product introduction. Adequate support is vital for the success and viability of new products, and as such the listing fee does not represent the existence of market power, but are instead a part of the normal negotiations and joint planning between grocery suppliers and wholesalers/retailers. [58]

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54 FoodWorks, submission no. 90, p. 34.

55 Coles, submission no. 225, p. 19.

56 Woolworths response to s 95ZK notice, cited with the consent of Woolworths.

57 ALDI, submission no. 81, p. 13.

58 Metcash, submission no. 181, p. 51.

GWF told the inquiry:

> Slotting fees reflect the competitive importance of particular in-store locations and are generally higher for new products. They are not payable on all products and may not be distinct fees but incorporated into trading terms.[59]

Industry associations also provided evidence on this topic, including the AFGC:

> The AFGC understands that such fees are common with retailers elsewhere in the world and reflect the competitive importance of particular instore locations. Such fees are likely to be higher for new products as retailers seek higher margins to cover additional costs and risks, but in so doing, they may well be an impediment to innovation or lead to the de-listing of lower margin products. They are accordingly likely to be part of performance based business plans, as individual suppliers may advise.
>
> Slotting fees also reflect the power of retailers to control what products are on their shelves and where. It is a reality that retailers have reduced the number of products or product variants in particular categories in recent years as they seek to minimise supply chain and administration costs and accommodate new private label (and other) products. The limitations on the exercise of such power are the strength of the brands and the reaction of consumers who can and do go elsewhere if their preferred brand is no longer available.[60]

Meanwhile, NARGA contended:

> Evidence exists of slotting fees that are so high that some manufacturers cannot do business with the MSCs. That is why small companies go to independents to start their business. There are numerous examples of this.[61]

Similarly, the AHBIC told the inquiry:

> The MSCs also exert bargaining power over product suppliers through their role as the suppliers of shelf space and advertising to the producer. Producer brands not only have to compete against other branded products and the own-label products of the MSCs, they also have compete for limited shelf space. This has further enhanced the bargaining position of the MSCs requiring the payment of listing fees for producer branded products in order to secure limited shelf space.[62]

Confidential information provided to this inquiry confirms that explicit payments associated with new product introductions are payable by some suppliers to some retailers. In addition, the inquiry was told in confidence:

> In some instances, fees that may otherwise be physically paid by a supplier to the retailer are instead provided by the supplier to the retailer as discounts, allowances or rebates. These ordinarily form part of the terms of trade between the supplier and retailer. They are deducted off invoice by the supplier or off remittance by the retailer to simplify the fee charging process. In other words, rather than the supplier physically paying certain fees to the retailer, these amounts are instead deducted as a percentage from amounts payable to the supplier.

Confidential information provided to the inquiry indicates new product fees are sometimes justified on the basis of recovering the cost of adding new products to the retailer's range, including the addition of fixtures and the cost of marking down deleted lines. The inquiry was also told in confidence that payments for new products are also used to provide additional support to new products.

Confidential evidence presented to this inquiry also indicates that some suppliers of strong brands are able to negotiate more favourable shelf space arrangements than other suppliers. The inquiry was told,

59 George Weston Foods, submission no. 138, pp. 8-9.

60 Australian Food and Grocery Council, submission no. 78, p. 8.

61 NARGA, submission no. 129, response to Q51, p. 65.

62 Australian Honey Bee Industry Council, submission no. 59, p. 10.

however, that any such arrangements do not guarantee that a supplier's products will not be deleted from the category.

In addition, as noted below, category average margins may also be utilised by MSCs as a benchmark in providing access to more favourable shelf space for products that meet or exceed the category average margin.

15.5.4 ACCC's views

The ACCC considers that the impact of shelf space fees on competition is ambiguous. On the one hand, such fees may enhance efficiency if they:

- Provide an efficient means of allocating scarce shelf space among competing products. In this scenario, new product listing fees are a form of rationing scarce shelf space with suppliers who are willing to pay the highest fees to gain access to the shelf space. Willingness to pay new product fees may also signal the supplier's confidence that the new product will be a success, thus increasing the chance that the products that are most likely to succeed will gain access to retail shelves.
- Reflect the retail costs of new product introduction. Retailers incur costs in evaluating new products and adding new products to their plan-o-grams and inventory systems. New product fees may be an efficient way to recoup the cost of new product evaluation and introduction.

On the other hand, such fees have the potential to be anti-competitive if they lead to the exclusion of suppliers and a weakening of competition at the supply level. This might arise if shelf space fees raise entry costs and disadvantage small suppliers.

The evidence presented to this inquiry is consistent with both efficiency and anti-competitive rationales for shelf space fees. The supply agreements provided to this inquiry on a confidential basis show that not all suppliers pay fees for new product introduction. This evidence is inconsistent with assertions that such fees seek to recover the costs of new product introduction and are thus efficient. Instead, it may be that such fees are mechanisms for buyers to extract additional payments from suppliers who do not have significant countervailing power.

Furthermore, the evidence indicates that some suppliers are able to negotiate more favourable shelf space locations. Such arrangements may have an efficiency basis and make it easier for consumers to find the leading products they wish to purchase. However, the arrangements may also reinforce existing brand strength by making it harder for weaker brands to attract consumers' attention and thus compete with leading, or more profitable, brands.

However, contrary to NARGA's assertions, the ACCC has not been presented with evidence of shelf space fees that are so high that some manufacturers, presumably smaller ones, cannot do business with the MSCs. Instead, the inquiry has heard of several small suppliers who have expanded their operations through their dealings with the MSCs In addition, as noted, above, Coles told the ACCC that over half of the stock keeping units (SKUs) in its stores are supplied from small suppliers.

The ACCC considers that there is an efficiency rationale for the payment of shelf space fees as a way of allocating scarce shelf space among competing products. Furthermore, shelf space fees may be an efficient way to recover the costs of introducing new products. However, the evidence suggests that the nature and level of such fees is such that they appear to be determined at least in part by the buyer's bargaining power and hence buyer power.

15.6 Trading terms

If the MSCs had buyer power, it would be expected that an exercise of such power would be visible during their negotiations with suppliers. The following section examines trading terms between the retailers and suppliers to determine whether there is any evidence of the MSCs using their buyer power in these negotiations.

15.6.1 What are trading terms?

The supplier-retailer/wholesaler relationship is governed by negotiated trading terms. Trading terms are negotiated for dry groceries (usually proprietary products; however, in some cases also private label products) and fresh produce. These terms set out the conditions on which goods will be supplied by the supplier to a retailer or wholesaler.

Trading terms cover a range of topics including the rejection of stock, specifications of stock to be provided, how stock will be delivered to the retailer, insurance requirements and dispute-resolution procedures. The trading terms also include clauses setting the cost of the product to the retailer and rebates or other discounts provided to the retailer or wholesaler by the supplier.

The ACCC has used its information-gathering powers to obtain copies of trading terms between a number of suppliers and retailers over periods of several years.

Given the number of products stocked at any one time by the MSCs, which run into the tens of thousands, the ACCC has been unable to examine all supply terms in place with all suppliers. The ACCC has attempted to obtain a general cross-section of trading terms across dry groceries and fresh produce including fruit and vegetables, fish and meat; from major suppliers and manufacturers to smaller suppliers and manufacturers in the market place; branded products as well as private label. As a result, the ACCC believes that the trading terms which it has examined are indicative of trading terms between suppliers and retailers more generally.

Business plans

The Australia Food and Grocery Council submitted that the relationship between suppliers and retailers is becoming more sophisticated and instead of merely relying on trading terms, suppliers have business plans that ‘recognise the mutual commercial goals of trading partners and the efficiencies inherent in individual trading relationships’.[63] The ACCC considers that while this may be the case for some larger suppliers, a significant number of smaller suppliers do not have business plans with the retailers and are left to solely negotiate on a trading term basis.

ALDI

The ACCC has obtained copies of documents relating to the relationship between suppliers and ALDI. These documents show that ALDI’s strategy in negotiating with suppliers is different to that of the other retailers and major wholesalers in the industry. ALDI does not negotiate rebates, discounts or allowances with suppliers.[64] Further, it provides payment to all suppliers within 30 days net.[65] For these reasons, much of the discussion below does not apply to suppliers’ negotiations with ALDI.

63 Australian Food and Grocery Council, submission no. 73, p. 2.

64 ALDI, submission no. 81, p. 15.

65 ibid.

15.6.2 Negotiation of purchase price

Dry packaged groceries

Suppliers and retailers have indicated to the ACCC that trading terms are fiercely negotiated between the retailer and the supplier. Trading terms for dry groceries appear to be generally negotiated for a defined period of between 12 months and two years (however, there are examples of terms being negotiated for substantially longer periods). Despite an end date often being provided on the agreement, the terms are usually stated to continue 'until further notice'. That is, until the terms are renegotiated between the parties, which can result in trading terms remaining in place for substantial periods of time.

Documentation obtained by the ACCC also indicates that trading terms can be renegotiated during the initial contract period, although this appears to occur rarely. Where renegotiations have occurred it appears that they have occurred for various reasons including changes to the retailers' warehousing practices.

The starting point for any negotiation on price for dry packaged groceries is the suppliers 'wholesale list price'. Prior to trading term negotiations, each supplier publishes a list price setting out the price of a particular unit (e.g. a case) of each of the grocery products it produces. The price paid by the retailer based on this list would then simply equate to the number of units of product required multiplied by the wholesale list price.

The wholesale list price is provided to all retailers who either already sell the products or could potentially stock the products. Suppliers have indicated to the ACCC that the same list price is provided to all retailers. Suppliers are required to confirm that they are providing individual retailers and wholesalers with the best price available in the market. In this way, all retailers and wholesalers have the same starting point for their negotiations on price. However, wholesale list prices are just that, a starting point for negotiations.

Generally, the wholesale list price is contained in a separate document to the trading terms.

The wholesale list price (for a supplier's proprietary products) may be changed by the supplier during the tem of the agreement with the retailer. Suppliers have indicated that they provide the retailers usually with at least one month's notice of any proposed change to wholesale price. Suppliers must also provide an explanation as to why the change in list price is required. Evidence provided to the ACCC indicates that the retailers will normally agree to such price changes, especially where there are exceptional circumstances, such as in the case of large unforeseen increases in input costs (e.g. the significant recent increases in the cost of grain as a result of a number of local and international factors).

Producers of private label products, who are generally selected by tender, are not usually able to change their supply price during the period of the agreement. Retailers expect that private label product suppliers will have taken into consideration likely input cost rises in the tender price.

Fresh produce

The ACCC understands that trading terms are also negotiated on a range of fresh produce supplied to the retailers. These terms may be negotiated in a contract similar to that for dry packaged groceries (for products such as poultry), or on an individual basis at the time of a particular order (this seems to be more common in the fruit and vegetable growing industries where price varies more frequently).

Price negotiations are slightly more complicated for fresh produce than for dry packaged groceries. Fresh produce prices are more likely to vary during the periods of supply as a result of changing market conditions. The ACCC understands that in the week before delivery of the fresh fruit and vegetables, price and volume is discussed between the supplier and retailer and a reasonably firm price is agreed. This price is then usually fixed for the week, but can be renegotiated if market conditions change prior to dispatch of the product. The price may be changed at the instigation of the retailer or supplier depending upon conditions in the market place. In this way, growers and wholesalers of fresh produce are able to ensure that their starting price takes current market fluctuations into consideration. For livestock, a representative price may be negotiated some time out from purchase; however, a firm price will be provided closer to the sale date as a result of changes in market conditions or the quality of the livestock.

15.6.3 Rebates and allowances

What are rebates and allowances?

Trading terms often include a number of rebates and allowances. These are negotiated between the parties and come off the list price in the case of dry groceries or negotiated price in the case of fresh produce. The rebates and allowances ultimately act as discounts and lower the price paid for the goods by the retailer or wholesaler. Rebates and allowances may be 'off invoice' or taken off the price of the goods before they are invoiced to the retailer/wholesaler, or they may be 'off remittance' where the retailer deducts them from the invoice price before payment. Rebates and allowances may be calculated as a percentage, or alternatively a specific dollar amount. The majority of rebates examined were calculated on a percentage basis, although cent per litre rebates are frequently used for products such as milk.

The rebates and allowances negotiated encompass price reductions for reasons such as large volume purchases; ullage, which provides some recompense for goods that may be damaged during transport and therefore rendered unsaleable; settlement discounts, which are for payment within a specified period; and warehousing allowances, where products are delivered to a retailer or wholesaler's distribution centre rather than delivered direct to store (to take into account the funds required to warehouse and distribute products on behalf of the supplier).

In addition to such rebates, suppliers and retailers will also often negotiate a promotional schedule for the products. Suppliers will either fully or partly fund these temporary reductions in price by providing additional rebates to retailers. In exchange, retailers will run a promotional program agreed with the supplier, which may include store displays and particular forms of advertising.

A small proportion of the rebates and allowances may be common to most retailers and wholesalers. The remainder of the rebates and allowances negotiated between the parties differ depending upon the supplier and retailer/wholesaler involved.

Factors influencing the negotiation of rebates and allowances

The ACCC has received evidence that indicates that during rebate negotiations suppliers take into consideration factors such as the category average margins required by retailers in their category of product, the complexity of distribution of the product and whether that distribution is being undertaken by the supplier or the retailer, and support that may be afforded to the supplier as a result of providing a specific rebate, such as increased promotional activity or acceptance as a 'preferred supplier' or other similar status.

As a result, trading terms do not simply encompass the different volumes of products purchased by various retailers and wholesalers. As GWF submitted:

> While volume is an important consideration, the volume of purchases does not in and of itself determine whether customers are 'like customers'. What is at issue, and suppliers are paying for, is the level of support that the retailer providers to the supplier. This varies dramatically from customer to customer and is not solely dependant on volume. [66]

As a result, a smaller store buying the same amounts of product from GWF as one of the MSCs, may still have different (and potentially less favourable) trading terms to the MSCs depending upon the level of support provided to the supplier.

Ultimately, rebates and allowances assist retailers and wholesalers to reduce the price paid for stock. This in turn, in a competitive environment, should lead to the reduction of prices paid by consumers (and in the case of wholesalers, being on-sold to retailers). In a less competitive environment, where there are less incentives for retailers to pass on the reduced costs, rebates and allowances may allow retailers to increase their margins at the expense of suppliers with little benefit to consumers.

15.6.4 Have trading terms changed over time?

Difficulties encountered in examining trading terms

Due to the complex nature of the pricing and rebate structures set out in the trading terms, it is difficult to precisely calculate what retailers are paying for various goods. It is therefore difficult to determine precisely what effect any changes to trading terms have had over the ultimate price at which retailers and wholesalers are able to purchase products. The difficulties encountered by the ACCC in examining and comparing trading terms were:

- In addition to rebates and allowances, suppliers will often assist retailers by providing further funding to reduce prices for promotion (funding either a proportion or the entirety of the promotion), on top of the rebates and allowances already provided. Without examining the timing of promotions and the level of supplier support, it is difficult to precisely determine how much increased or decreased trading terms are affecting retailers' purchase price.
- Due to the nature of rebates—which are designed to compensate retailers for various factors related to the supply, distribution and retailing of the products, and the inherent differences in the models operated by retailers, wholesalers and suppliers—it is difficult to compare trading terms between retailers; and for the one retailer, between individual suppliers.
- Reasons for the changes in trading terms are not always readily apparent from the documentation provided to the ACCC. It is difficult to identify, for particular individual increases or decreases in trading terms, the reasons behind those changes and whether it indicates solely an exercise of buyer power on the retailer's behalf or other external factors.
- It is not only the price and rebate structure which has the potential to affect growers and producers. While price is an important factor, retailers may also attempt to obtain additional contractual benefits such as longer settlement terms, clauses which require suppliers to provide the product to the retailer at the best available price in the market, or the shifting of financial risks or costs associated with the supply of the product back to suppliers.

66 George Weston Foods, submission no. 138, p. 7.

Pricing and rebate structures

Documents obtained from both retailers and suppliers under the ACCC's information-gathering powers dating back to 2002 indicate that generally, rebates provided to the MSCs have increased slightly in the retailer's favour since this time. Of the documents examined, 59 per cent of the trading terms demonstrated overall increased rebates over the period.

Leaving aside this general trend, it should be noted that there were some occasions where the level of rebates provided to the retailers actually decreased over the period. Of the trading terms examined, 16.5 per cent had rebates that had fallen between 2002 and 2008. In some cases, this decrease was due to an increase in settlement terms and either a decrease or removal of a rebate allocated for payment within a specific shorter timeframe.

There were also a number of products on which the rebates offered remained static over the entire period. Trading terms remained static where they had not been renegotiated during the period or, in instances where negotiations had occurred, where such negotiations had not resulted in a variation to the rebates already in place. Of the documents examined, 24.5 per cent had rebate levels which remained static from 2002 to 2008.

Larger suppliers v smaller suppliers

Information was sought about trading terms for similar products sourced by both large-scale and small suppliers.

In general, for fresh fruit and vegetable produce, larger suppliers either provided identical, or a slightly greater, percentage of rebates to retailers than smaller suppliers. A significant amount of evidence obtained during the course of the inquiry from several growers and suppliers indicated that large suppliers often set up their business to supply to the MSCs, who in turn purchase a large percentage of their product. As a result, larger suppliers may substantially depend on the MSCs to move the volume of produce for which they are geared. The MSCs are likely to be aware of this fact and may then use it to their advantage to obtain more profitable trading terms. The ability for MSCs to exercise their buyer power in such a manner depends on the alternative channels available to the supplier to sell their product and the extent to which the product supplied is seen as a 'must have' item by retailers. It also depends on the MSCs' ability to source quality goods, within their specifications and on a reliable basis from some other source(s).

The documents obtained indicate that the trend generally reverses for large suppliers/manufacturers of dry grocery products. Smaller suppliers (who usually supply less well known brands) provide larger percentages of rebates to retailers than larger suppliers (who generally supply the better known grocery brands). Evidence provided to the ACCC during this inquiry indicates that this may be partly as a result of retailers needing to stock certain well known brands due to consumer loyalty towards those brands. This reduces the value of the retailer's outside options and so increases the supplier's negotiating strength. It may also arise because of the greater efficiencies in buying from a large retailer. These factors may enable the supplier to negotiate better terms from retailers than may otherwise have been the case.

In contrast, the balance of bargaining strength is generally tipped in favour of the retailer/wholesaler in negotiations with suppliers of brands that do not enjoy strong consumer loyalty. Thus suppliers of those brands may not be able to negotiate as favourable terms as suppliers of leading brands.

Metcash

As discussed previously in this report, Metcash operate in a substantially different manner to the MSCs. While the MSCs operate as vertically integrated retailers, Metcash has no retailing arm (although it does maintain equity in a number of large independent retailer companies). As a result, the trading terms negotiated with Metcash are designed to compensate Metcash for different factors to the MSCs and for services provided by Metcash (such as a charge-through service), which are not provided by the MSCs. As a result it is very difficult to compare the trading terms obtained by the MSCs with those obtained by Metcash.

The ACCC received fewer trading term documents evidencing terms from 2002 to 2008 for suppliers dealing with Metcash compared to those provided for the MSCs and therefore less weight should be given to the analysis. Analysis of the documents provided indicates that rebates to Metcash have increased over the period by a slightly higher percentage than those provided to the MSCs. Metcash had a similar percentage of total trading terms that had increased over the period compared to the MSCs, a slightly higher percentage of terms where rebates had fallen and a slightly lower percentage of terms that had remained stable.

Metcash's ability to compete with other retailers on trading terms and issues arising out of Metcash's supply of grocery items to independent retailers have been examined previously in chapter 7 of this report and therefore will not be discussed here.

ACCC's view

Generally, it appears that retailers in recent times have been able to obtain greater levels of rebates from suppliers. It is, however, difficult in many cases to determine why these rebates were increased and whether there was any external justification for a change in rebates and pricing. A variety of justifications outlined in the documents obtained by the ACCC are discussed in more detail later in this chapter. However, it appears that the results in negotiated outcomes reflect the MSCs' and Metcash's substantial ability to require improved terms, particularly from large suppliers of produce and secondary brands in packaged groceries.

Non-price factors

Settlement terms

The ACCC has received evidence which indicates that the MSCs in particular have recently attempted to extend the period of time in which they are able to pay the supplier for their goods (essentially purchasing goods on credit). Such requests appear to have been made for both fresh and dry produce.

Payment terms outlined in the documents provided to the ACCC are generally either 14 or 30 days although there are examples of payment terms that are both shorter and longer than these figures (including payment terms of up to 60 days).

Payment terms can either be on a net basis (for example, payment 30 days after invoice) or can be defined in the trading term agreement on the basis of weighted averages. The result of calculating payment terms on a weighted average basis is that the actual time for payment often becomes significantly longer than the specified 14 or 30 days. This may cause difficulties for smaller companies for whom cash flow may be a more important factor.

The topic of settlement terms and Woolworths' ability to negotiate substantial settlement terms were discussed during the course of the public hearings. The following line of questioning was put to Mr Michael Luscombe, Chief Executive Officer of Woolworths:

> MR O'DONOVAN: Okay. Now it would be fair to say that all things being equal that a supplier would prefer cash on delivery terms to waiting a month or two months to be paid?
>
> MR LUSCOMBE: Correct.
>
> MR O'DONOVAN: You would agree to that. Yes, all right. So the fact that your suppliers are—give up, I suppose cash on delivery and accept delayed payment is a reflection to some degree of the bargaining power that Woolworths has in respect of those suppliers. Would you agree with that?
>
> MR LUSCOMBE: That would be a fair assumption, yes.
>
> MR O'DONOVAN: All right. So it would be fair to say that because of Woolworths' size and your importance in the market to suppliers that it's able to negotiate terms that are very favourable to Woolworths and suppliers are forced to give up conditions which they would if the bargaining power were more equal would [sic] insist upon?
>
> MR LUSCOMBE: I'm not—are you talking viz a viz [sic] other retailers?
>
> MR O'DONOVAN: No. Only if they had a choice in terms of how they dealt with Woolworths if they felt that they had market power, more market power than they do have would you agree that they would choose to give less generous payment terms to Woolworths?
>
> MR LUSCOMBE: I think that's a natural conclusion that one could reach.[67]

The MSCs clearly use their bargaining power in this sense when they are able to do so. The ACCC received confidential information that indicates that the MSCs have approached suppliers to advise that they intend to extend the periods for payment so as to standardise their terms. The ACCC understands that to reduce the settlement periods, suppliers will be required to provide an additional settlement rebate. The ACCC understands smaller suppliers have been told that if they do not either provide longer payment terms or additional rebates, they may lose their supply contract. Given the volumes of product that flow through the MSCs, and the distinct lack of alternative routes of sale particularly for dry grocery products, de-listing could quite possibly result in the overall failure of the product (and potentially the supplier company).

In general, the examples of trading terms obtained by the ACCC indicate that payment or credit terms have remained fairly static over the period examined. The example above is believed to be relatively recent, which may explain why this has not been noted in the agreements provided to the ACCC. Despite this, there are clear (albeit isolated) examples through the documents where the MSCs in particular have been able to increase their credit terms (e.g. from 10 to 14 days) over a period of time while still claiming the same level of settlement rebates from the supplier. The ACCC is unable to categorically state that these changes are solely as a result of the retailer exercising the power referred to by Mr Luscombe above, although this would seem to be one explanation. There are also isolated examples of settlement terms being extended significantly; however, the settlement rebate previously provided has been completely removed as a result.

Bundling of trading terms

In recent years, the MSCs in particular have moved from an approach of having a number of individual terms and rebates, to bundling or combining rebates. Instead of negotiating, for example, seven separate rebates with a supplier dealing with various supply issues, the retailer will instead negotiate one comprehensive rebate. The trading term document often does not clearly explain exactly what

67 ACCC, public hearing transcript, Melbourne, 19 May 2008, pp 32–33.

factors have been taken into account in determining the bundled rebate. Generally, it appears that where terms have been bundled the retailer and supplier have entered into a business plan designed to specify both parties' intentions for the product into the future.

It appears from the documents provided to the ACCC that the vast majority of suppliers who currently operate on a bundled term basis with the retailers are large manufacturers.

Smaller operators appear to largely operate on the earlier trading terms model, possibly as they are not big enough to require the retailer to enter into an agreed business plan.

Larger suppliers, who have advised they operate on a bundled term basis with the MSCs, have largely indicated that they are pleased with the arrangement. Generally suppliers believe that the bundled terms have reduced the complexity of the negotiations for sale price and have reduced the need for negotiations for the rebates provided (which the ACCC understands in the past could occur quite frequently).

The ACCC has not received any submissions from suppliers to indicate that they believed the bundling of terms was a concern. As a result, this issue has not been examined in any further detail.

Requirement to provide best price to retailers and wholesalers

The vast majority of trading terms provided to the ACCC contain a provision which requires suppliers to acknowledge they are providing the product to the retailer at the best possible price in the marketplace.

Confidentially, some suppliers have raised concerns to the ACCC about the apparent unfairness of such a clause. Woolworths have indicated that they do require suppliers to confirm that they are providing Woolworths with the best price. However, they indicated that this confirmation related only to the 'wholesale list price' and did not take into consideration trading terms. As Mr Ian Dunn, Senior Business Manager, Trade Relations for Woolworths, stated during the public hearing:

> It relates to buying at the best rack, the best volume price. It doesn't refer to buying at the best net price, the supplier may well offer deals in the market place, or trading terms that are better to someone else, but generally, as Mr Luscombe says, suppliers have the same list price in the market place anyway, and therefore it tends not to apply.[68]

Mr Luscombe stated he was not aware of any instance where this clause had been used against a supplier of dry packaged groceries.[69]

Further evidence provided during the course of the public hearing indicated that this term has been a standard clause in Woolworths' supply agreements for some time, potentially dating back to the 1970s. Despite its longevity, it is clear that the inclusion of this term in trading term negotiations is of concern to some suppliers.

Suppliers have confidentially indicated that even with the clause being limited to list price, the clause is unfair. Suppliers indicated that the inclusion of such a clause limits they extent that they can negotiate a list price to start negotiations with the retailers which would take into consideration any non-price terms peculiar to their contract with a particular retailer. They argue that even if they were in a position of being able to successfully negotiate a higher list price with one of the MSCs or Metcash, they would not be able to use this price in any event as it would not be the 'best price' offered in the market and would therefore breach their trading terms.

Woolworths has previously been involved in litigation in relation to their requirement to purchase at a

68 ibid., p. 99.

69 ibid., p. 98.

'best price', in *Australian Competition and Consumer Commission (ACCC) v Australian Safeway Stores (No. 3)*.[70] In that case, however, Woolworths had taken matters one step further by deleting whole ranges of a supplier's product as a result of independent stores purchasing the products at what was presumed to be a lower price than Woolworths was achieving. There have been no allegations of any such conduct provided by suppliers to the ACCC during this inquiry. This case is examined in further detail in chapter 14 of this report.

Risk and costs passed back to suppliers

Evidence has also been received from suppliers that costs associated with the supply of the products are being pushed back along the supply chain and ultimately incurred by suppliers.

One example of such conduct, raised on numerous occasions during the course of this inquiry, is the introduction of reusable plastic crates for fresh fruit and vegetable products supplied to the MSCs. Many suppliers have indicated that the introduction of the crates has resulted in increased costs. Growers have noted that each of the MSCs use different reusable crates.

The major issues about the crates arise when product is rejected by the MSCs. As both MSCs use different crates, if a grower wishes to attempt to sell product to the other MSC, the produce must be unpacked and then repacked in the required crate. Similarly, if produce is rejected, but deemed suitable to sell on the central markets, it needs to be unpacked from the crates and repacked into cartons or other modes for storage. Suppliers submitted that this crate requirement has greatly increased their costs, in particular labour costs, in the above circumstances. Further, suppliers also submitted that as these crates are 'shelf ready' the retailer has actually reduced the amount of labour required to display the product for sale. Suppliers have indicated that they have not been compensated for this factor by way of reduced rebates.

Unilateral contract variations

Concerns regarding unilateral contract variations were raised in a number of submissions to the ACCC. Unilateral variation clauses allow one party to a contract to vary the contract without the agreement of the other party. Various representative bodies have anecdotally claimed that such clauses are a concern for suppliers as they provide retailers with an opportunity to misuse their position of power which exists in many of these relationships. More specifically (but without much in the way of further detail) issues were identified in retailers' changes to agreed specifications for fruit and vegetables without prior negotiation with the supplier.

Evidence provided to the inquiry by growers who supply produce to the retailers indicated that they were generally happy in their relationship with retailers, and in relation to the allegation outlined above, stated that generally retailers only rejected produce when it was outside specifications negotiated in the contract (despite the fact there could be some disagreement over the interpretation of the specifications between the parties).

Evidence has been obtained from growers of fresh produce which indicates that there are occasions, following the setting of a purchase price for the product, when the MSCs may come back to them and ask for additional price assistance, to help them match a lower price available at another retailer. While this appears to be an example of the MSC potentially altering agreed trading terms, the growers have indicated that they generally have a choice as to whether they provide the price assistance requested by the MSCs. It is possible, however, that a grower who holds a particularly weak position in the negotiations may feel obliged to provide such additional assistance, whether they wish to or not.

70 *Australian Competition and Consumer Commission (ACCC) v Australian Safeway Stores (No. 3)* (2001) 119 FCR 1.

However, even in these instances, reduced price is often associated with lower quality produce being supplied to the retailer.

Evidence was also provided to the inquiry that in the case of dry grocery products, the MSCs would demand compensation if they had to lower the shelf price of products which had been de-listed, to help clear the old product. Suppliers indicated that generally they were happy to assist in these cases as they normally had a new product to take the place of the de-listed product, and therefore were keen to get the new product on shelf as quickly as possible. Technically, this is a unilateral variation of contract terms.

Further evidence was provided which indicated that retailers requested suppliers of products which are specifically targeted by shop lifters, to provide additional funding to compensate retailers for the amount of product stolen. If the supplier was not able to provide such assistance, the products involved would be moved off the shelf and placed in a secure area to prevent the products from being stolen. Suppliers appear to have been concerned that such a move off shelf may have affected the product's sales performance and accordingly have agreed to make payments.

Despite the fact that growers and suppliers have provided evidence to the inquiry advising that they are largely content in their dealings with retailers, representative organisations have continued to allege that there are issues relating to unilateral contract variations in the marketplace. Representative organisations have suggested that the reason why evidence of these issues was not provided to the ACCC during this inquiry was due to a fear of retribution from the retailers. Given that it was made clear that evidence to this inquiry could be provided confidentially, the ACCC finds it difficult to understand why suppliers with such concerns have not come forward. When the totality of the evidence obtained by the ACCC is looked at, it appears that few instances of unilateral contract variation take place.

15.6.5 Specific factors that have resulted in changes to pricing and rebates

Woolworths

Changes to distribution and warehousing practices

As discussed earlier in this report, the MSCs have moved towards a centralised warehouse system to reduce their costs of doing business. Woolworths started implementing such a system in 2005-06 and negotiations with suppliers following this date in relation to trading terms take into account this change in practice.

Suppliers were requested to provide additional rebates to acknowledge the fact that Woolworths would now undertake various steps in the supply chain that the suppliers would previously have performed themselves. As a result, suppliers' costs would be reduced and therefore Woolworths required this be acknowledged in the trading terms through a reduced purchase price.

Coles

Changes to distribution and warehousing practices

Similar to Woolworths, Coles also implemented a centralised warehouse system. This occurred in 2007, approximately a year after Woolworths had made similar changes. At this time, Coles sought to vary trading terms with its suppliers to take these changes into consideration.

The correspondence obtained about this issue indicates that Coles advised suppliers that rebates of a specific percentage to account for the new warehousing practices and savings for suppliers would be added to the rebates previously negotiated. It would appear that in some cases, Coles' suppliers were actually able to negotiate reduced rebates in other areas to partly offset this rise. The general trend for rebates following these negotiations was a small increase in Coles' favour.

ACCC's view

As discussed above, over the last six years, rebates have generally improved in the retailer's favour. While the general trend indicates that rebates are increasing, this trend is not universal across all products or all suppliers.

The ACCC believes that at least some of the additional rebates provided to retailers arise as a result of the retailer's buyer power. The ACCC cannot however rule out that some increases have occurred as a result of other external factors. The extent to which retailers are able to leverage their buyer power in negotiations regarding trading terms depends largely on the alternative options open to the supplier to sell their product as well as the strength of the supplier's brand (and the subsequent need for the retailer to have the product on shelf).

Confidential information provided to the inquiry indicates that increased payments from suppliers (in conjunction with a number of other factors) are assisting retailers to raise their gross profits.

The ACCC has examined the evidence provided to the inquiry in relation to the concerns listed above, including unilateral contract variations and the requirement to provide a 'best price' guarantee to retailers. The ACCC notes that this conduct occurs as a result of contractual relationships between suppliers and retailers. As a result of the evidence provided to the inquiry, the ACCC has not identified any instances of conduct which would raise concerns under the Act.

15.7 Trading terms by size of retailer

As discussed in chapter 14, a buyer with buyer power will usually be able to extract lower prices and better terms and conditions from suppliers than buyers who do not have buyer power.

A relevant issue is what competitive effect, if any, differential trading terms that reflect buyer power have on retailers without buyer power. As explained in chapter 14, the theoretical answer to this question is ambiguous. There is a suggestion, for example, that retailers who lack buyer power will benefit from a larger retailer's buyer power because suppliers may find it strategically optimal to set a lower wholesale price for smaller buyers.

A contrary argument, however, is that larger retailers' buyer power will instead force up the supply prices paid by competing retailers. This so-called 'waterbed effect' arguably arises when an increase in buyer power lowers the large buyer's supply price. As a consequence, suppliers seek to recover lost profits by charging higher prices to other smaller buyers that do not have buyer power.

15.7.1 Waterbed effect?

NARGA submitted:

> There is no doubt that the independent sector suffers from the waterbed effect on pricing.[71]

According to NARGA, the experience of milk prices in Western Australia since deregulation in that state in July 2000 provides evidence of the existence of a waterbed effect in relation to the supply of milk.

71 NARGA, submission no. 129, response to Q56.

NARGA defines a waterbed effect as follows:

> The 'waterbed effect' is the term used to describe the result when a large player in a market demands lower wholesale prices from suppliers, forcing those suppliers to increase prices to other customers to bring earnings back to a sustainable level. The large body in the middle of the waterbed forces up smaller bodies on the sides.[72]

NARGA considered that the supermarkets are the largest players in the milk market and have demanded low wholesale prices for private label milk. NARGA provided volume and price data for supermarket milk sales that, according to NARGA, shows that private label sales of milk have increased from 41.8 per cent of sales in 2000–01 to 55.1 per cent in 2005–06. During that time, NARGA submitted, the average shelf price of branded regular milk has increased by 19.6 per cent while the price of private label milk has increased by 4.7 per cent. NARGA also submitted that since 2005–06, prices for branded milk in indicative markets have increased by a further 30 cents per litre. NARGA contended that this shows that low prices paid for private label milk are being supported by higher prices in the branded milk range, giving large supermarket chains a competitive advantage at the expense of smaller stores who do not sell generic milk, resulting in higher average milk prices.

As discussed in chapter 12, increases in retail prices charged by the MSCs for milk have largely tracked movements in wholesale prices. Prices for branded milk have increased more than prices for private label milk, both at the wholesale and the retail levels. The divergence in retail prices for branded and private label milk is therefore reflective of a divergence in the respective wholesale price of these products. This divergence is primarily a reflection of three factors:

- vigorous competition amongst retailers for private label contracts
- the buyer power of the MSCs
- the rigidity of private label contracts which means it is more difficult to pass on increases in processor costs of production in a timely manner.

In evidence given confidentially at hearings, and in response to s. 95ZK notices, processors indicated that they did not generally increase wholesale branded milk prices to offset increases in the costs of supplying private label products to the MSCs. One processor did indicate that increased costs for branded products have been able to be recovered in a more timely manner, and another indicated that prices of branded products have sometimes been increased to off-set overall cost increases, both for branded and housebrand products.

However, more generally, processors were generally of the view that:

> If Woolworths or Coles is particularly aggressive in negotiating terms it doesn't mean [we] will try to recover more from other customers because the reality is, it couldn't recover any shortfall from other customers because of market shares.

In a more general response to the issue of whether the (on average) more favourable trading terms of Coles and Woolworths create a waterbed effect, Coles submitted:

> There have been allegations that Coles and Woolworths receive better terms from suppliers than independent retailers, creating a so-called 'waterbed effect' on convenience store owners. If this effect existed, it would involve C&W obtaining allegedly favourable terms from suppliers resulting in suppliers increasing the prices they charge to other grocery retailers.
>
> Coles cannot comment in detail on the terms provided by suppliers to other retailers. However, it believes that the price it pays for goods into its distribution centres and direct into retail stores are comparable to those available to other supermarket chains and wholesalers. Discounts and rebates

72 NARGA, submission no. 129, p. 12.

> offered by suppliers are influenced by sales volume and while confidential are believed to be similar. They are also generally dependent on retailer/wholesaler performance in settlement days and the provision of marketing support in ranging, layout and promotions. [73]

GWF also rejected implicitly the existence of a waterbed effect in its submission:

> If a MSC puts pressure on GWF to lower prices we are not in a position to 'make this up' elsewhere.[74]

ACCC's views

Chapter 14 provided a discussion of the economic theory of the waterbed argument. It noted that there are two potential explanations for such an effect, if it exists—a cost-shifting explanation and an explanation that relies on changes to upstream market structure. As further noted in chapter 14, the existence of a waterbed effect in any sector is far from universally accepted.

The ACCC does not consider a waterbed effect to be a significant issue either in relation to groceries generally or milk in particular. Further, the ACCC considers that the cost-shifting explanation violates standard axioms of profit maximisation: If the supplier is able to charge smaller buyers higher prices and the larger buyer negotiates a price reduction, why did it not do so before? These views are borne out by the evidence in submissions stating that suppliers do not have the capacity to recover or make up any margin losses by increasing prices to other customers. The ACCC also notes the evidence that, in consequence of the MSCs' increased sales of generic milk, many independent retailers now also have increased access to such cheaper generic milk.

The ACCC accepts that in many sectors there have been changes in the structure of upstream sectors as a result of consolidation and rationalisation. These changes will often improve a supplier's bargaining strength and thus enable the supplier to negotiate more favourable prices. However, these structural changes have often occurred over long periods of time, reflecting dynamic adjustments to issues that are beyond the control of individual suppliers, such as deregulation and globalisation. The ACCC has found little evidence that these structural changes are the result of a waterbed effect and thus does not consider it to be a significant issue in relation to the pricing of groceries.

15.8 Incentives to innovate

Buyer power may reduce suppliers' incentives to innovate if it results in suppliers earning lower returns. Suppliers may respond to these reduced returns by under-investing in innovation because they expect to make an inadequate return on those investments. A reduction in innovation will generally be associated with a reduction in variety, which is usually associated with a reduction in consumer choice.

A contrary view is that large buyers may have an incentive to develop long-term relationships with suppliers and to co-sponsor investments with those suppliers. This may enhance the incentives to innovate.

Furthermore, the presence of large buyers may also increase the incentives for suppliers to innovate as such innovation may increase their ability to sell their products to alternative buyers.

The ACCC does not consider that buyer power is significantly impacting on suppliers' incentives to innovate at this time. This issue is discussed in more detail in the next chapter.

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73 Coles, confidential submission, May 2008, cited with the permission of Coles.

74 George Weston Foods, submission no. 138, p. 11.

15.9 Consumer behaviour

Consumer behaviour may act as a constraint on buyer power by indirectly reducing the credibility of a buyer's threat to walk away from negotiations or de-list a product. This would occur if the product in question has sufficient brand loyalty so that consumers would switch to alternative retailers if they are no longer able to buy the product from their usual supermarket.

For instance, Coles told the inquiry:

> There are products and brand that are fundamental to the success of any Australian grocery retailing business. These include products that have no real substitutes such as Vegemite and Gillette razor blades and those which customers demand despite the existence of substitutes such as Tim Tams, Weet-bix and Coca Cola. Coles cannot afford not to stock these types of products and suppliers are well aware of the power of their brand. [75]

There are likely to be few brands, however, that have sufficiently strong consumer loyalty to actually cause large numbers of consumers to switch stores in response to non-availability at another store. More likely responses are to either not buy another brand or not buy any competing product. For instance, FoodWorks told the inquiry:

> If a desired brand is not available, it is unlikely the consumer will search for the product in another retailer. If the substitute is at a value that outweighs the cost of shopping elsewhere they will readily buy the substitute. [76]

On the other hand, NARGA said:

> In some instances, consumers who purchase the bulk of their requirements from Coles or Woolworths will have to go to an independent store to buy a specific brand or product that the majors have discontinued. This is quite common and has resulted in Woolworths announcing a strategy to try to change their ranging to be more store-specific. However if a customer asks a Coles or Woolworths store to stock a particular product easily available elsewhere quite often they are told it cannot be done. [77]

The ACCC's consumer survey found that for 69 per cent of respondents, brand name is at least 'somewhat important', with 28 per cent considering brand name to be 'very important'. The survey also provided some guidance on likely consumer behaviour if their preferred brand is not available in-store. Forty-six per cent of respondents said that they would buy a different brand if their preferred brand was not available while 23 per cent would not buy any product at all. Only 10 per cent would switch to a private label product and 19 per cent would go to another store.

There are a number of characteristics of consumer shopping behaviour and habits that are likely to limit the extent to which consumers will switch stores in response to the unavailability of their preferred brand. In particular, consumers who are time-poor and have a strong preference for one-stop convenience shopping are less likely to shop around if their preferred brand is unavailable.

The supplier will be worse off in all cases of consumer switching in response to the non-availability of its product except where the consumer switches stores to buy the product elsewhere. If the consumer does not buy any product at all then the supermarket will lose the value of the lost sale but retain the remainder of the value of the consumer's shopping basket, so its loss will be relatively small. The impact on the retailers will be ambiguous if the consumer switches to another brand, which may have higher

75 Coles, submission no. 225, p. 32.
76 FoodWorks, submission no. 90, p. 35.
77 NARGA, submission no. 129, p. 58.

or lower margins than the unavailable product. On the other hand, if the consumer switches stores, the supermarket will potentially lose the consumer's entire shopping basket.

The ACCC considers that consumer behaviour will provide at best a weak constraint on the abuse of any buyer power.

15.10 Demand withholding

The concept of demand withholding refers to buyers demanding less than would otherwise be the case (withholding demand) in order to reduce the price paid to sellers. If buyers have retail market power, the reduced volumes could be sold at a higher price and higher margin.

For demand withholding to be of concern, a number of characteristics must be present:

- There must be a large number of sellers who sell into a market and receive the market determined price for their produce. This contrasts with many grocery buyer/seller relationships where supply prices are determined by negotiation between the buyer and seller. Thus, the appropriate analytical framework is the 'monopsony power' model discussed in appendix I.
- Unit product costs must rise with volumes (decreasing returns to scale or upward sloping supply curve).
- There must be a small number of buyers who are able to exercise their buying power to influence volumes traded and hence wholesale market price.
- For demand withholding to be of concern at a retail level it must be the case that buyers have market power at the retail level and thus are able to sell the lower volumes at a higher retail price. If this is the case then consumers are worse off.

The inquiry has been provided with little evidence of demand withholding. The ACCC considers that this practice is unlikely to be an issue in relation to packaged groceries because of the nature of the buyer-seller relationship. Demand withholding is also unlikely to be consistent with the way fresh produce is supplied to the retail level (usually directly or through consolidators rather than through wholesale markets). Although the MSCs do acquire some fresh produce through wholesale markets, their buyer power in those markets would not appear sufficient to influence volumes traded and hence wholesale market price.

The ACCC does note that one allegation has been made of demand withholding by retailers so as to push down the price of a product—namely, avocados—purchased in a wholesale market setting. Avocados Australia told the inquiry that the MSCs had maintained high retail prices and margins despite increased volumes at the wholesale level and falling returns to growers. According to Avocados Australia, the MSCs' actions caused a supply glut that persisted for several months. Avocados Australia told the inquiry that it had discussed this pricing behaviour with both Woolworths and Coles who 'had great difficulty in understanding that [the deliberate maintaining of high retail prices and margins] and accepting it'.[78] The ACCC has closely examined the relevant data regarding retail and wholesale movements of avocado prices during the period in question. The ACCC has concluded on the evidence available to date that the data does not appear to support the existence of the type of pricing behaviour alleged by Avocados Australia and therefore there is no compelling evidence that the MSCs engaged in the type of demand withholding behaviour in relation to avocados as has been alleged. However, the ACCC will carefully examine any further relevant evidence that comes to light.

78 ACCC, public hearing transcript, Brisbane, 3 April 2008, pp. 128–30.

15.11 Conclusions on buyer power

The inquiry was provided with little evidence to substantiate allegations of buyer power being exercised in an anti-competitive or unconscionable manner. Having said that, however, there were some complaints of buyer power being exercised where the complainant appeared to be genuinely reluctant to provide information to the ACCC out of concern about retribution if details were provided to the ACCC and investigated.

15.11.1 Packaged groceries

In relation to packaged groceries, the ACCC considers that the MSCs and Metcash have buyer power, and while suppliers of key brands also possess strong seller power that may offset some of the corresponding buyer power, few suppliers have strong countervailing power across their entire product range.

The ACCC has formed its views for the following reasons:

- Generally buyers' outside options are more valuable than sellers'. For many sellers of packaged groceries, the grocery distribution channel is the major route to consumers. Although there may be alternatives, they are not sufficient to offset volumes lost by walking away from the grocery buyer.
- The MSCs and Metcash are large in absolute and relative terms in relation to most sellers.
- Suppliers are generally more dependent upon the relationship with buyers than the buyer. The amount of product purchased from a supplier by a buyer often represents a large proportion of the supplier's sales and accordingly, income. The loss of this income may cause significant financial stress to the supplier. Buyers on the other hand purchase large numbers of products from a range of suppliers. On this basis, the loss of product provided by one supplier is likely to be comparatively less financially significant to the buyer
- While there is some efficiency rationale for fees and charges for accessing shelf space, their differential application suggests the use of buyer power. However, there is little evidence that this is having a major impact on competition at the supplier level.
- MSCs generally buy products on better trading terms than other buyers, and those trading terms have generally become more favourable over time.

15.11.2 Fresh produce

The MSCs have varying degrees of buyer power in their dealings with suppliers of fresh produce. However, this buyer power is generally weaker than that associated with packaged groceries. The degree of buyer power that an MSC has depends to a large degree on the grower's ability to take advantage of the available outside options.

The ACCC considers that the evidence in relation to fresh produce is inconsistent with arguments that the MSCs are long-term oppressors of growers. Rather, the evidence indicates that, overall, growers have a range of options other than direct supply to the MSCs. The evidence that some buyers have remained in business relations with the MSCs for many years without contractual reasons for doing so suggests that there are benefits from doing so.

16 The role of private label products

Key points

- Sales of private label products are increasing as a share of total grocery sales. However, private label penetration is lower in Australia than in some overseas countries.
- The growth of private labels is not consistent across categories. This suggests that the success of private labels largely reflects consumer preferences.
- The introduction of private label products offers consumers additional choice and is pro-competitive, other things being equal.
- Competition from private labels puts suppliers of many branded products under pressure to offer improved trading terms or more promotions to compete.
- Growth of private label products has the potential to distort competition because retailers may have incentives to:
  - promote their own labels in preference to proprietary brands otherwise preferred by consumers by giving private labels preferential shelf space
  - retain additional promotional benefits obtained from branded suppliers rather than passing those benefits to consumers in the form of lower retail prices.
- There is some limited evidence that in order to preserve the price advantage of private label products, retailers do not always accept promotional price reductions offered by suppliers.
- There is little evidence that:
  - retailers allocate shelf space to private label products in preference to profitable branded labels, though private labels are given prominent positions
  - growth of private label products is reducing incentives for new product innovation
  - the growth of private label products is weakening competition at the supplier level.

16.1 Introduction

A supermarket's total product offering consists of a range of proprietary brands (owned by the supplier/manufacturer) and private label brands.[1] Consistent with several overseas countries, the overall sales share of private label brands has been rising in Australia.

Chapter 14 examined the economic theory underlying buyer power, of which private label products are a potential source.

The growth of private label product sales has been a significant trend in Australian grocery retailing and one that has raised concerns from consumers and suppliers. This chapter seeks to analyse the key competition issues relating to private label products. These issues relate to the potential of the introduction and growth of private label products enhancing the buyer power of the major supermarket chains' (MSCs') and harming the competitiveness within vertical supply chains.

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1 Private label grocery products (also known as home brands, own brands, store brands or generics) are products manufactured or provided by one company (which may also produce its own proprietary branded products in competition with the private label) for sale under a retailer's brand.

16.2 Role and impact of brands

An assessment of the impact of private label products on competition and consumers requires an understanding of the benefits and costs of brands in general and of private label brands in particular.

A key role for brands, whether proprietary or private, is to differentiate a product from its competitor products and to position the branded product relative to rivals. By doing so, brands convey a certain degree of pricing power on the brand owner, including some ability to set prices. This can be particularly attractive for producers of otherwise homogeneous products—such as eggs and milk—because product differentiation reduces the intensity of price competition. Price competition is lessened because non-price factors such as quality and packaging also influence consumer choice and reduce the degree of substitutability between competing brands.

Branding can create customer loyalty. This grants producers an advantage over rival producers of new products. In relation to private label products, if a retailer is able to build consumer loyalty for its private label products, it is less likely that consumers will switch to other products. In addition, as private label products are only available at a particular retailer, if a retailer is able to build consumer loyalty for its private label products, it will also build loyalty to its stores.

What could potentially be thought of as negative effects of brands on competition must be considered in light of possible positive effects, such as greater product differentiation and consumer choice. In particular, by giving consumers greater choice of product attributes, brands can satisfy a more diverse range of consumer demands.

In addition, brands can be used to provide information to consumers about the quality of products they are buying and thus reduce the risk of a consumer making an inappropriate choice of product. This is particularly the case for so-called ‘experience goods’ where quality is generally difficult to ascertain before buying the item. Many grocery products are likely to be experience goods.

A positive experience with a particular brand conveys information to the consumer about the likely quality of repeat purchases of both that particular product and other products bearing the same brand name. This information can also reduce the time taken to make an appropriate choice, which reduces consumers’ search costs.

16.3 Private label brands in Australian grocery retailing

Private label products have been in Australian supermarkets since at least the 1960s, with the focus on lower prices/lower quality products. Sales of these private label products were historically relatively low, received limited consumer acceptance and offered little competitive threat to suppliers of branded products.

More recently, the MSCs have refocused their efforts on retailing private label products. This has included offering products across a greater number of categories and at different quality and price levels.

The inquiry was told by a number of parties that ALDI’s entry into the Australian market in 2001 fundamentally altered the role of private labels in Australian grocery retailing and the private label strategies that the MSCs had adopted. This was because ALDI predominantly supplied its own private label products that were pitched directly at the branded products offered by the existing retailers. ALDI’s entry prompted the MSCs to reconsider their private label strategies, with Coles and Woolworths increasing their focus on private labels and introducing ‘tiered’ private label ranges to compete with

ALDI's everyday low price (EDLP) strategy.[2] Table 16.1 shows the private labels offered by Australian grocery retailers.

Table 16.1 Private labels offered by Australian grocery retailers

Retailer/banner group	Private labels
Woolworths	Homebrand (tier 1) Fresh (tier 2) Select (tier 2) Organics (tier 2) Naytura (tier 2) Freefrom (tier 2)
Coles	Coles Smart Buy (tier 1) You'll Love Coles (tier 2) Coles Finest (tier 3) Various legacy brands
ALDI	Range of private labels
Franklins	No Frills
Metcash/IGA	Black & Gold IGA
FoodWorks	Black & Gold Best Buy
Foodland	Foodland
SPAR/5 Star	Fabulous
Supabarn	Black & Gold Supabarn

16.3.1 Private label tiers

As noted above, each MSC has changed its private label strategy from a focus on lower priced/lower quality products to tiered products that are differentiated in terms of price and quality, and which compete directly with proprietary branded products.

Coles told the inquiry that it has adopted a three-tiered strategy. Its Coles Smart Buy label is the budget/tier 1 label positioned to be priced the same as or below competitors' EDLP private label product.[3]

Coles also told the inquiry that its tier 2 You'll Love Coles range of private label products is generally priced at least 10 per cent below the price of a group of target competitor products.[4] You'll Love Coles products are also priced with reference to the comparable Coles Smart Buy product. According to Coles, the You'll Love Coles products are not generally discounted and must not be priced below the comparable Coles Smart Buy product.[5]

Finally, Coles told the inquiry that it also offers the tier 3 Coles Finest premium range of private label products. It currently has 34 products in this range, which are primarily used around peak seasonal periods like Christmas. Coles does not consider that Woolworths' Select products compete with Coles Finest.[6]

2 See, for example, Australian Food and Grocery Council, submission no. 73, p. 2; Metcash, submission no. 74, p. 15; Coles, submission no. 157, freshlogic report, p. 41; ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 56; ALDI, submission no. 81, p. 5.

3 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 9.

4 ibid, p. 46.

5 ibid, p. 52.

6 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 63.

In contrast, Woolworths told the inquiry it has adopted a two-tiered private label strategy. Adopting a similar pricing strategy to Coles, Woolworths said that its Homebrand product (tier1) is priced to match the price of competitors' comparable private label products. The Select label is targeted at the market leader and is generally priced to be cheaper than the market leading brand.[7] Its Organics, Naytura and Freefrom private label brands cater to specific dietary needs.[8]

Woolworths does not consider that its Select range competes with the You'll Love Coles range. Contrary to Coles' view, Woolworths considers that You'll Love Coles products are aimed more at second- and third-tier proprietary brands. According to Woolworths, the Coles Finest range is more closely aligned with Woolworths' Select range in terms of quality. However, as the Coles Finest range is currently quite small there are, according to Woolworths, few Select products that have a direct Coles Finest competitor.[9]

The ACCC considers that the pricing strategies adopted by Coles and Woolworths for their premium private label products generally result in those private label products having lower shelf prices than branded products of comparable quality. This suggests that private label products can be a source of price competition for those proprietary branded products.

16.3.2 Private label products' share of grocery sales

Estimates vary as to the share of private labels in total grocery sales. For instance, IBISWorld estimated that private labels accounted for around 12 per cent of the packaged grocery market in 2007.[10] Freshlogic, in comparison, reported that private labels accounted for 18 per cent of grocery sales in full service supermarkets (FSS).[11] Similarly, the Nielsen Company (Nielsen) reported that the share of private label products in packaged grocery sales was 19.9 per cent in the year to July 2007.[12]

Retail World estimated that private labels represented 15 per cent of Coles' total grocery sales and 13 per cent of Woolworths' in 2007.[13] The inquiry has been provided with the MSCs' private label shares on a confidential basis. These estimates are broadly consistent with the publicly available figures.

There is agreement, however, that the share of private labels in Australian grocery sales has been rising over the past few years. For example, Nielsen estimated that private label sales increased by 4.7 per cent in the year to July 2007, slightly ahead of overall growth in total packaged grocery sales. Nevertheless, ACNielsen reported that private label growth has been slower than expected.[14] Metcash submitted that private label sales as a share of defined packaged groceries have grown from 16 per cent in 2002 to 19 per cent in 2006.[15] Coles told the inquiry:

> ... as we've reported recently in our sales results, you know, our sales are growing double digit on house brand particularly at the Smart Buy and You'll Love Coles end of the world as customers look for better value.[16]

7 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 40.

8 Woolworths Supermarkets 1997–2008, Woolworths brands, accessed 19 June 2008, www.woolworths.com.au/Vendors/privatelabel/WOWBrands.

9 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 40.

10 IBISWorld *Industry Report 2008*, *Supermarkets and other grocery (except convenience stores) in Australia*, p. 10.

11 Coles, submission no. 157, freshlogic report, p. 41.

12 2007 Nielsen report, p. 20.

13 Barry Flanagan (Ed.), *Retail World's Australasian grocery guide 2008*, Retail Media, Sydney, 2008, p. 37.

14 Nielsen report, 2007, p. 20.

15 Metcash, submission no. 74, p. 15.

16 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 56.

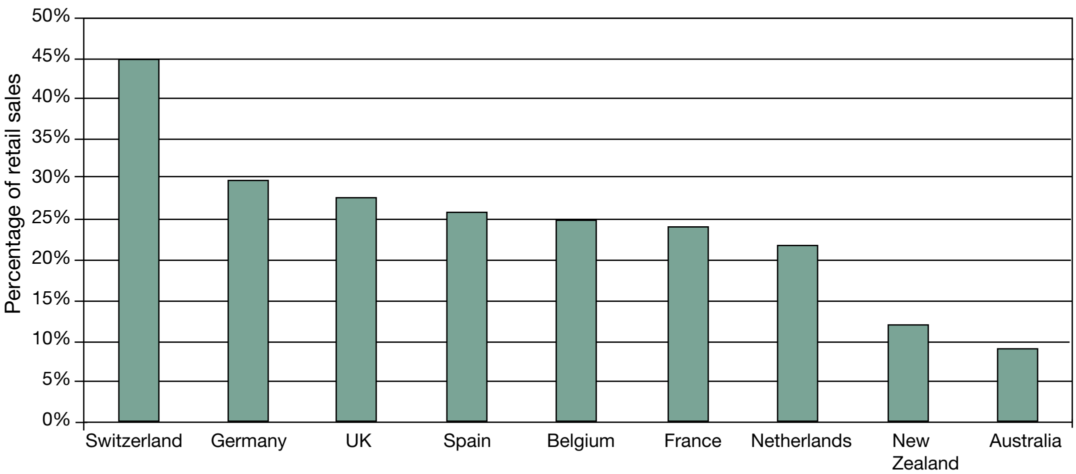
Similarly, Woolworths partly attributed the increase in gross margin in its supermarket division in the first half of 2008 to the success of its private labels.[17]

FoodWorks told the inquiry that Woolworths is targeting a 25 per cent share of sales for private labels.[18]

Other confidential evidence provided by the MSCs relating to private label sales over the past five years also shows that the private labels' share of grocery sales is increasing.

Nevertheless, private label penetration is relatively low in Australia compared with some overseas countries. For example, the United Kingdom's Competition Commission reported that in 2006 around one-third of sales of food and drinks in the UK were of private label products.[19] Coles provided data to the inquiry, shown in chart 16.1, that shows Australia had a small percentage of private labels compared with seven of the other eight countries surveyed by Nielsen in 2005. Although there has been some growth in private label sales in Australia since 2005, these figures suggest that there might be room for further expansion of private labels in Australia.

Chart 16.1 Value shares of private labels in retail sales, various countries, 2005



Source: Coles, confidential submission, 23 May 2008, p. 48

Recognising the potential for further growth, the major retailers have adopted strategies that aim to increase sales of private label products. For instance, Coles told the inquiry that it is planning to invest in its Coles Finest range in the future and is generally putting more focus on 'generics'.[20]

17 Woolworths Ltd, Presentation of company results, half year ended 30/12/2007, accessed 19 June 2008, http://library.corporateir.net/library/14/144/144044/items/281095/2008%20Half%20Year%20.Results%20Presentation.pdf.

18 FoodWorks, submission no. 90, p. 45.

19 Competition Commission, *Supply of Groceries in the UK Market Investigation, Provisional Finding report*, appendix 8(11–1), 31 October 2007.

20 ACCC, public hearing transcript, Melbourne, 26 May 2008, pp. 53, 56.

FoodWorks and Metcash told the inquiry that they are aiming for private labels to represent 10 per cent and 12 to 15 per cent of sales respectively.[21] However, Metcash explained that it has set what it considers to be a modest target for private labels sales share because it considers the presence of proprietary brands on independent retailers' shelves are one of their key competitive advantages.[22]

16.3.3 Shares across product categories

Evidence presented to the inquiry shows that the sales share of private label products varies across product categories and retailers. National Foods, for instance, told the inquiry that the share of private labels is generally higher in the staple product categories where there is less product differentiation. According to National Foods, private label penetration tends to be lower in categories such as yoghurt that are highly differentiated, with strong support for branded products.[23]

A supplier said that private label products will generally sell more in categories where there is a low level of consumer brand engagement. For instance, the supplier said that there is still a significant amount of brand loyalty in the cheese category:

> 'to put it simply, people may not want to have a *No Frills* cheese or a You'll Love Coles cheese on their cheese platter if people are coming over. They would rather have a brand offering'.

The supplier also told the inquiry that the MSCs had attempted to introduce private label yoghurt 'a couple of times' but consumers had 'rejected it basically'. However, according to National Foods, overseas trends suggest that private label shares may increase in the more differentiated categories as retailers shift their focus to those categories.[24]

Chart 16.2 shows private label products' share in various grocery categories in 2002 and 2007.[25] Consistent with inquiry participants' views expressed above, it indicates that private labels have achieved greatest share in categories where the product might otherwise be homogeneous to consumers, and consumer choice would be based mainly on price. For instance, private labels have achieved substantial market shares in milk (over 50 per cent in 2007), and eggs and sugar (both over 60 per cent). In contrast, private labels have a relatively low share of sales in the biscuits, fruit juices and drinks categories. As noted above, sales of private label yoghurt products are also relatively low.

The evidence also shows that growth in sales of private label products varies by category, as can be seen in Chart 16.3. From 2002 to 2007, for instance, sales of private label bread increased by nearly 140 per cent. Sales of private label butter, cheese and cooking oils also increased by over 40 per cent during that time. In contrast, private label sales in margarine, dry pasta and frozen vegetables have grown by less than 20 per cent.

The cross-category differences in both absolute shares and sales growth of private labels suggest a range of factors determine the success of such products. Not all of these factors are likely to be under the control of retailers.

The ACCC considers that the tiered private label strategies of the MSCs, which seek to introduce more product differentiation, have contributed to the growth in private label sales. Nevertheless, private label products appear to have less consumer appeal in some categories where loyalty to existing proprietary brands is relatively strong. It remains to be seen whether this loyalty will prevent Australian grocery retailers from increasing sales of private labels to levels comparable with retailers overseas.

21 FoodWorks, submission no. 90, p. 45; Metcash, submission no. 74, p. 52.

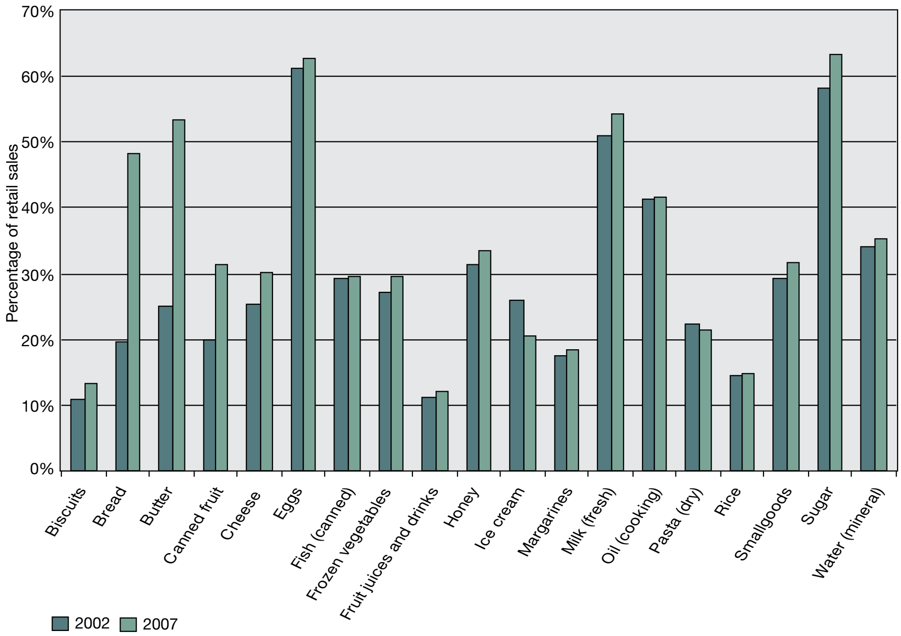
22 Metcash, submission no. 74, p. 52.

23 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 16.

24 ACCC, public hearing transcript, Melbourne, 15 May 2008, p. 16.

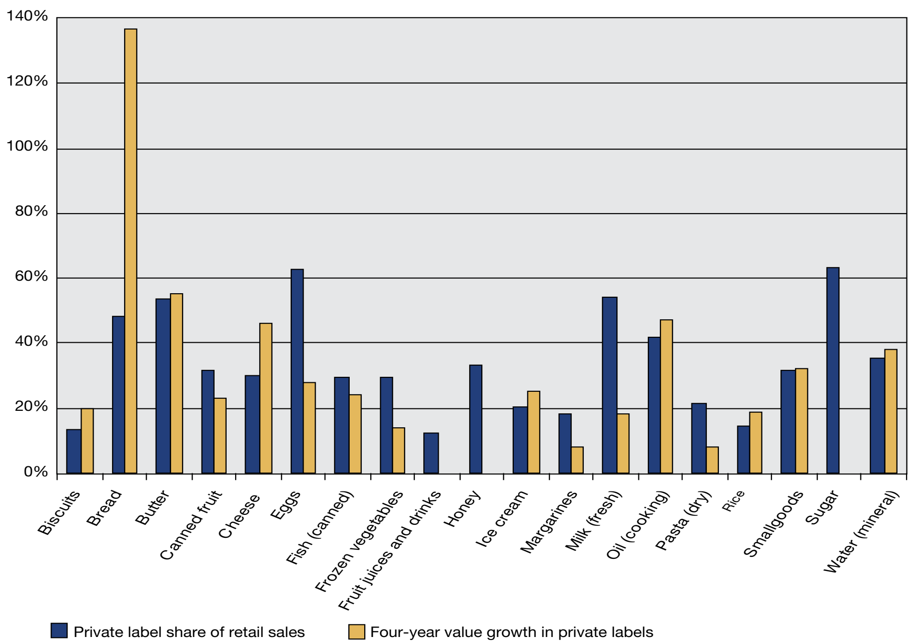
25 Coles, submission no 157, freshlogic report, p. 41.

Chart 16.2 Private label products share of total category sales, 2002 and 2007



Source: Coles, submission no. 157, p. 41

Chart 16.3 Private label products' shares of category sales 2007, and growth in value, 2002–07



Source: Coles freshlogic report, p. 41

16.4 Quality of private label products

The degree of substitutability between private label products and proprietary brands will reflect consumers' perceptions of quality. If consumers consider a private label product to be a close substitute for the targeted proprietary brand, they are more likely to switch to that brand in response to its generally lower price. Even if consumers perceive the quality of private label products to be lower than branded products, they still may decide to change their purchasing patterns if the price difference is large enough. Either way, private labels can provide a source of price competition from proprietary branded products.

According to the ACCC's consumer survey, over 80 per cent of shoppers buy private label products.[26] Although most consumers buy private label products, there appears to be a consumer perception that private label products are of lesser quality than their branded rivals.

This inquiry gathered considerable evidence, some of it in confidence from suppliers, about the physical characteristics of private label products. Some of this evidence indicates that for products such as milk, eggs, cheese and bread, there is little, if any, difference between the private label product and the equivalent proprietary branded product. Similarly, the NSW Farmers Association noted that for milk and eggs, the private label and branded products are identical to one another. In relation to milk, the products often come from the same factory.[27]

Despite limited physical differences, the retail price of the private label milk brand is usually considerably less than the comparable proprietary branded product. For instance, Coles sells both Coles Smart Buy and You'll Love Coles private label milk products. Coles told the inquiry that these products differ in quality only in the 'eyes of the customer', with the key difference being the source of the product. You'll Love Coles milk is generally sourced from the local area (within the state) whereas milk for Coles Smart Buy may also be sourced from interstate.[28] According to Coles, customers attach value to knowing they are supporting local farmers and local producers. Coles charges around 20 per cent more for You'll Love Coles full cream 2-litre milk compared with the equivalent Coles Smart Buy product.[29]

In other cases, the inquiry heard that retailers specify ingredients and packaging that differentiate the private label from its branded rivals, making direct quality comparisons difficult. For instance, ALDI provided the inquiry with product specifications for a number of its private label products on a confidential basis, which showed varying degrees of differentiation compared with the targeted proprietary branded product. Similarly, Woolworths submitted that its Select range often offers products without directly comparable branded competitors. Nevertheless, Woolworths contended that its quality specifications are equal to or better than the market leader in 99 per cent of cases.[30] Finally, Coles submitted that some private labels are aimed at providing a slightly different product to existing proprietary brands, thereby increasing consumer choice.[31]

ACCC's view

Consumers' perceptions of quality are essentially subjective and can be based on a whole range of factors other than the objective quality of the product. Therefore, in the context of this report, the ACCC

26 ACCC consumer survey, 2008.

27 NSW Farmers Association, submission no. 155, pp. 18, 19.

28 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 69.

29 ibid, p. 70.

30 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 49.

31 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 55.

does not draw conclusions regarding the quality of private label products in relation to proprietary branded products.

However, as part of the ACCC's preliminary work in developing the GROCERYchoice website (discussed in chapter 1), the ACCC engaged an independent product tester to ensure that the grocery products in the comparison baskets across supermarket retailers were of equivalent quality and therefore would allow meaningful price comparisons to be made. This was necessary because the various baskets include a range of private label products that need to be matched to other brand or private label products available from other retailers. While has been found that some private label products are equivalent in quality to leading brand proprietary products, this is not always the case.

Moreover, independent of the quality differences, the different price points the MSCs offer private labels adds to the choice available to consumers and creates competitive tensions with branded products.

16.5 Impact on choice

The introduction of new private label products may be criticised as an attempt by the MSCs to force lower cost products on consumers and diminish consumer choice by deleting branded products or narrowing the range previously available to consumers.

The inquiry has been provided with evidence that some consumers consider that private labels lead to a reduction in consumer choice. The following comment is indicative of consumer concerns:

> Coles and Woolies seem to be 'getting rid' of choice, there are so many of their own brands and other brands are disappearing, no free choice.[32]

A key issue in determining the effect of private labels on consumer choice is assessing whether it is supermarket rather than consumer preferences that are driving the introduction and success of private label products.

On this issue, the National Association of Retail Grocers of Australia submitted that, regardless of customer preference, the major chains have reduced product ranges and deleted brands, replacing them with private label brands:

> Desired brands have been delisted now, regardless of customer preferences. Many suppliers complain about being taken off the shelf to make way for a house brand.[33]

However, Coles stated during hearings that:

> I actually think that customers are demanding it [private labels] because they're saying I'm going to go to Aldi to buy that pasta or that milk or those eggs unless you have a product of similar quality and better value …
>
> We don't accept the proposition that the drive to home brands and restricted range is reflective of lack of competition and customer responsiveness on the part of Coles and Woolworths–absolutely not.[34]

Coles further added:

> We think they're [private labels] pro choice for customers and pro competitive.[35]

Coles also disagreed that customers would prefer a bigger range of brands and less focus on generics.

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32 Georgina Close, submission no. 105.

33 National Association of Retail Grocers of Australia, submission no. 129, response to question 53.

34 ACCC, public hearing transcript, Melbourne, 26 May 2008, pp. 56, 58.

35 ibid, p. 56.

It cited research that Australians have a 79 per cent propensity to buy private labels, which suggested to Coles that, over time, customers are accepting the brands more and more. Nevertheless, Coles noted:

> From a category management perspective we've got a job to be done to ensure we range the most relevant range of branded and home brands for our customers because customers are faced with a choice. They will walk if we don't range according to what they need.[36]

Woolworths agreed that there has been a reduction in range in some categories but said that this represents a different choice for consumers, rather than a reduction in choice.[37] Further, Woolworths submitted that the deleted product may be from another category. A supplier told the inquiry that it does a lot of research work on consumer behaviour—particularly of consumers shifting between brands.

ACCC's view

The introduction of a private label product at a lower price point to existing comparable proprietary brands offers consumers additional choice and is pro-competitive, all other things being constant.

The ACCC is satisfied that consumers as a whole are not worse off from the growth in private label products. There is little evidence that MSCs are able to override consumer preferences because if they were to do so, they would risk losing customers to other retailers. This implies that although some consumers may be unable to purchase their favourite brands, the success of private label products does not indicate the consumers are worse off overall.

16.6 Benefits of private label products to retailers

The inquiry was told that retailers offer private label products for a number of reasons, including to[38]:

- increase margins
- build customer loyalty by offering products that are not available in competitors' stores
- enable the retailer's store brand loyalty to be leveraged into private label offerings, although this must be balanced against the risk that the store's image will be damaged if consumers' quality expectations are not met
- give retailers greater control over supply because supply of private label products is generally subject to fixed-price long-term contracts
- give retailers greater control over quality
- reduce the influence of branded manufacturers and correspondingly improve the retailers' buying power.

Some of these reasons, such as giving the retailer greater control over supply and quality, may enhance the retailer's efficiency. Whether some of these reasons, including attempts to increase margins and buyer power, can have an anti-competitive effect is considered in more detail below.

36 ibid, p. 57.

37 Woolworths, public excerpts from confidential transcript, 19 May 2008, p. 7.

38 See FoodWorks, submission no. 90, p. 24; George Weston Foods, submission no. 138, pp. 10, 12; Insight Partners, submission no. 122, p. 2; Metcash, submission no. 74, p. 16; Coles, submission no. 157, freshlogic report, p. 41; ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 54.

16.7 Profitability of private label products

For the MSCs, private labels can be used to increase gross margins. Indeed, achieving such an outcome is a key component of the MSCs' private label strategies. For instance, Woolworths Ltd reported an increase in gross profit margins for its supermarket division (including petrol and liquor) to 23.69 per cent for the first half of 2008. This contrasts with gross margins of 23.01 per cent (2005–06) and 23.41 per cent (2006–07) for Woolworths' supermarket division (including petrol and liquor). In its presentation of company results, Woolworths attributed this increase, among other things, to the success of its private label offerings.[39] Woolworths told the inquiry that it expects to continue to get a positive contribution to earnings before interest and tax (EBIT) from customers switching from the market leader to the Select product range and that it has been able to maintain its target margins.[40]

Further, Coles told the inquiry that one of the objectives of its private label strategy is to generate higher percentage margins off a lower dollar price, typically five to six percentage points in additional gross margin.[41]

As Coles explained:

> If we get a homebrand right we expect to deliver better value to customers and increased EBIT margin too.[42]

Woolworths elaborated, submitting:

> It is not a general rule that we make really good margins on all [private label] products. In some categories we actually don't make a great margin.[43]

Coles also expressed the qualification that although private labels earn a higher percentage gross margin for the retailer, the lower prices paid by consumers mean the margin returns in cents are not necessarily higher than for branded products. Further, depending on relative sales volumes between private label and proprietary brands as well as total category sales growth, Coles explained that the overall dollar sales and profits returned could be higher or lower. Coles also argued that its private label strategy requires a substantial investment in product and brand development as well as quality management. According to Coles, these costs will only be recovered in the long term if customers accept the products.[44]

The inquiry was told in confidence that unlike the MSCs, independent retailers do not necessarily earn higher margins on private labels as they do not have the volume to drive supply prices down. For smaller retailers, the role of private label products is often to provide price competition to the MSCs rather than a strategy to increase profit margins. Private labels can also be used to attract a particular customer demographic.[45]

16.7.1 Supply prices for private label products

The inquiry was told that, unlike branded products, private label products are generally supplied on terms and conditions specified in contracts of one to two years' duration. These contracts are awarded

39 Woolworths Ltd, *Presentation of company results, half year ended 30 December 2007*, available at http://media.corporate-ir.net/media_files/irol/14/144044/asx/2008%20Half%20Year%20 Results%20Presentation.pdf, accessed 14 May 2008.

40 ACCC, public hearing transcript, Melbourne, 19 May 2008, pp. 17–18.

41 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 53.

42 ibid, p. 55.

43 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 17.

44 Coles, submission no. 225, p. 38.

45 ACCC, public hearing transcript, Sydney, 1 April 2008, p. 53.

in several ways, including by tender and online auction. Coles told the inquiry that a tender document will contain product specifications, delivery requirements, estimated volumes and supply terms and conditions.[46]

As the price of private label products is typically less than comparable proprietary brands, the increase in gross margins is mainly achieved by buying the product at a lower price than the comparable branded product. One reason this is possible is that the supplier does not advertise or promote the product and therefore does not need to recover these costs in supply prices. As Woolworths explained:

> Private label doesn't carry the cost of marketing that branded product do, we can clearly make a better margin and yet deliver it to the customer at a lower price.[47]

Participants told the inquiry of a number of other benefits that the supply of private label products to supermarkets can provide for suppliers, particularly smaller ones, notwithstanding that such supply is often on a low-margin, fixed-price basis with associated price risk. These benefits include[48]:

- keeping a competitor from increasing volume and reaping benefits from economies of scale
- providing the ability to enter the marketplace and/or gain access to a customer base—though Woolworths stated it would be unusual for it to award all of a tender for a significant product to a start-up company because of a lack of track record in the production or delivery of that product[49]
- providing stability of income and guaranteed volumes for the contract period, which can provide a base for new product development and product innovation
- utilising surplus production capacity
- for small and medium size suppliers, achieving economies of scale that may not otherwise be realised
- improving negotiating position with retailers in relation to branded supply, which may provide an additional incentive to offer a low private label price (see section 16.8.1).

These benefits might be of such value to some suppliers that they are willing to offer prices close to marginal cost. Indeed, this inquiry has heard confidential evidence that some suppliers are making a loss on private label contracts. While this is generally because of unforeseen changes in market conditions, the inquiry has heard confidential evidence that there is also a willingness on the part of some suppliers to earn a lower than normal return on private label sales in order to obtain the benefits of supplying branded products to the large supermarket chains.

On the other hand, a number of suppliers of proprietary branded groceries told the inquiry that they choose not to supply private label products. This is often because the suppliers do not want to compromise their own brand image.

For instance, the inquiry was told during confidential hearings:

> We're in the business of building our brand, not someone else's. We know what happens when you go down that road, you effectively put yourself once your brand disappears, in the hands of the retailer … Their margins are comfortable, your margin may be compressed rather severely. What happens is you end up with a lot of volume business but the earnings are very small and there's uncertainty about continuity of market share.

46 Coles, submission no. 225, p. 13.

47 ACCC public hearing transcript, Melbourne, 19 May 2008, p. 13.

48 See, for example, ALDI, submission no. 81, p.13; Coles, submission no. 225, p. 12.

49 Woolworths, confidential transcript, 19 May 2008, cited with the consent of Woolworths.

ACCC's view

The ACCC accepts that not all private label products earn high margins for the MSCs. Further, high margins are not necessarily indicative of weak competition. In a competitive market, however, it would be expected that initially high margins on private label products would fall over time as rivals respond by introducing competing products. Evidence suggests, however, that MSCs expect to maintain or even increase the gross margins earned on sales of private label products.

Although some suppliers choose not to supply private label products, evidence indicates that for many suppliers, particularly smaller ones, a private label contract with an MSC provides many benefits. Therefore, competition to win such a contract is generally strong.

16.8 Buyer power

As noted above, one of the reasons that retailers sell private label products is an attempt to reduce the influence of suppliers of proprietary brands. If successful, this would increase the bargaining power of the retailer and thus may increase their buyer power. As noted previously, the competitive effects of buyer power are ambiguous. However, a number of potential competition concerns associated with buyer power arising from private label products have been raised at this inquiry, including:

- retailers may allocate premium shelf space to their own brands in preference to competing suppliers, which could affect competition at the retail level
- branded products may be de-listed to make way for private labels, which could affect competition at the supply level
- private labels may weaken incentives for product innovation
- the impact of 'copycat packaging' of private labels.

16.8.1 Shelf space allocation

Retailers with private label products have the ability and incentive to allocate shelf space and positioning in a way that favours the retailer's brand.

If the suppliers excluded from supermarket shelves to make way for private labels have no viable alternative distribution channels, their access to final consumers may be foreclosed. In this way, competition at the supplier level could be distorted if independent suppliers exit the upstream market in response to reduced sales and/or prices.

An additional competition concern considered by this inquiry is whether MSCs tie the allocation of shelf space for proprietary brands to the winning of a private label contract. The ACCC considers that if this were the case, retailers may be able to extract excessive discounts for private label contracts from suppliers, leading to higher barriers to entry at the supply level.

The inquiry did not hear evidence that this is the case. Indeed, Woolworths stated that, when deciding whether to accept a tender offer for a private label, it does not consider how far it can push the supplier's margin down.[50] However, the inquiry heard confidential evidence that the winning of a private label contract can make it easier for a supplier to negotiate access to shelf space for its branded products. On the other hand, another supplier told the inquiry in confidence that it has not had difficulty getting access for branded products where it is not the supplier of private label products.

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50 Woolworths, confidential transcript, 19 May 2008, cited with the consent of Woolworths.

As discussed in more detail in chapter 15, the layout of a store, including the placement on shelves of individual products within a category, is determined by retailers using a 'plan-o-gram'. Retailers told the inquiry that allocations to a particular position on a shelf are determined by the product's contribution to profit, with those making the greatest contribution displayed in a more favourable location. This is generally the space between eye and hip level.

In relation to shelf space allocation, George Weston Foods (GWF) told the inquiry[51]:

> MSCs and independent retailers actively manage shelf placement and promotional offers and tend to support the best performing lines which may adversely affect smaller suppliers. The 'shelf squeeze' has become more acute recently as retailers have reduced the number of products or product variants in particular categories in order minimise supply chain costs and accommodate new and private label products.

The Australian Honey Bee Industry Council (AHBIC) submitted[52]:

> The expansion of own-label products further increases the bargaining position of MSCs in several regards through providing them with the ability to undermine a producer's branded products. This can be achieved through placing producer's products in less well-located shelf positions, raising the retail price of the branded product, or substituting the branded product for their own-label products.

In response, Coles submitted[53]:

> Coles confirms that it does actively manage its store layouts and ranging. It ought not to surprise the Commission or suppliers that prominence is given to best performing lines. However, Coles does not agree with George Weston's contention that this necessarily disadvantages small suppliers. Rather, it disadvantages brands which do not perform to requirements.

Confidential evidence presented to this inquiry confirms that MSCs do place their private label products in favourable positions and may give those products priority over branded products.

16.8.2 Product de-listing

As well as allocating premium shelf space to their own products, retailers may be able to credibly threaten to de-list rival proprietary branded products in order to make space available for new private labels, thus increasing their buyer power. The category review process that may ultimately lead to product deletion was discussed in chapter 15.

Metcash explained the threat of deletion as follows[54]:

> The MSCs can credibly threaten to delist products and/or ranges of suppliers as a ranging strategy or to favour their private label brands. In a highly concentrated market, the delisting of products by the MSCs could result in suppliers exiting the market thus further intensifying the level of market [supplier] concentration.

GWF told the inquiry[55]:

> The rise of 'private labels' over the past five years is well established, and retailers are using private labels to keep pressure on branded products and keep the prices that they acquire at down. The growth of private labels in some product categories is over 40%. In some categories this growth is fuelled by the delisting process pursuant to which many enduring national brands are disappearing and suppliers are not being given the opportunity to replace failing brands or SKUs with new products.

51 GWF, submission no. 138, pp. 8–9.
52 AHBIC, submission no. 59, p. 9.
53 Coles, submission no. 225, p. 19.
54 Metcash, submission no. 74, p. 51.
55 GWF, submission no. 138, pp. 9–10.

The concern that the retailers' push to increase private label sales may lead to deletion of profitable branded products was also raised by Mrs Mac's[56]:

> We have experienced a decision by a major retailer to delete our brand in substitution for a range of home brand product after what had been many years of successful business for both parties. It represented a significant quantity of our business and no other brand is now to be permitted in this particular category.

In contrast, another supplier told the inquiry in confidence that the advent of private label products has not made it harder for its branded products to stay on the shelf or caused more deletions of its products.

MSCs noted that any product can be deleted if it does not meet performance criteria. Coles submitted[57]:

> As shelf-space is finite, Coles conducts periodic reviews of each product category (including its private label products) to ensure that the category is providing appropriate customer choice and also meeting Coles' requirements regarding financial performance. This does mean that, from time to time, proprietary branded products may be removed from the range and/or that private label products are removed from the range.

In this regard, Coles told the inquiry that from time to time it has launched private labels that have not succeeded because the product has not lived up to consumers' expectations.[58] Indeed, confidential information provided by the MSCs regarding product deletion confirmed that private labels have been deleted in recent times.

Further, Woolworths stated that it is not safe to assume that the introduction of a private label leads to the deletion of an equivalent brand. Even though 'one-in-one-out' is the general rule, it is possible that the deleted product will be from another category. Nevertheless, Woolworths confirmed that products most at risk of deletion are second or third tier brands that are not selling well. However, a private label product not selling well could also be deleted.[59] This evidence is consistent with claims made by Metcash and Fonterra that the number three to five brands in certain product categories have in many cases been replaced with private labels. [60]

However, the ACCC heard confidential evidence from a small supplier of both proprietary branded and private label products that the introduction of private labels does not necessarily harm sales of its competing proprietary brands. That supplier also told the inquiry that private label products can actually increase sales of smaller manufacturers' branded products by increasing public awareness of the category's products in general through the MSCs' advertising.

The competitive response of suppliers to the introduction of private labels

Suppliers are generally given notice that their product is at risk of deletion and are given an opportunity to improve the at-risk product's performance. Coles told the inquiry that the response of suppliers of proprietary brands to the introduction of private labels varies. According to Coles, some suppliers are more concerned about brand positioning and quality rather than price reductions to improve competitiveness. On the other hand, Coles said that some suppliers are 'very interested in reducing price'.[61]

56 Mrs Mac's, submission no. 152, p. 1.

57 Coles, submission no. 225, p. 38.

58 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 62.

59 Woolworths response to s. 95ZK notice, cited with the consent of Woolworths.

60 Fonterra Brands (Australia) Pty Ltd, submission no. 85, p. 8; Metcash, submission no. 74, p. 51.

61 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 58.

The ACCC has been told that branded suppliers' competitive responses to the threat of deletion and the introduction of private label products may include a combination of:

- a reduction in wholesale list price, although the inquiry was told that suppliers generally do not reduce wholesale prices to all customers in response to a threat from a specific retailer
- an increase in off-invoice discounts, including increased case deals or promotional payments that are intended to reduce the retail price of the product
- an increase in advertising by the supplier.

For example, Coles told the inquiry that private labels create competition for shelf space and can introduce competition into categories where little may have existed before.[62] Coles used Cadbury block chocolate as an example of a supplier's competitive response to the introduction of a competing private label. According to Coles, the regular selling price of a Cadbury block of chocolate was reduced from $4.69 to $3.99 for 22 weeks. This was in response to the introduction of You'll Love Coles Belgian Chocolate range. According to Coles, the introduction of the private label product has[63]:

> … caused quite a change of heart from that leading supplier both in terms of more promotional support to lower price of their products and in fact just recently to lower the regular price for a six month period.

Further, Coles argued that promotional contributions as a percentage of its business have increased over time as has the number of stock keeping units (SKUs) that are run on promotion. According to Coles, these changes are at least in part driven by the very competitive nature of house brands in that they cause every supplier to respond.[64]

Woolworths agreed with the proposition put to it at the public hearing by the ACCC that, in its role as gatekeeper to consumers, it controls decisions about lowering retail prices and may choose to not accept the benefits of lower wholesale prices or permit increased promotions. However, Woolworths did not agree with the proposition that the existence of private label products provides a positive incentive for it to act that way. Instead, Woolworths told the inquiry that if a leading brand is 'on special' more often as a result of competition from private labels, this has the effect of increasing Woolworths' attractiveness to customers. In this regard Woolworths told the inquiry that it had never chosen not to pass lower wholesale prices on because of its desire to preserve the retail price of the competing Select product.

Further, Coles told the inquiry[65]:

> We should be clear we don't accept every promotional proposition that's put to us. I don't believe we've made any different decisions because of house brands.

In addition, a supplier told the inquiry it has not encountered reluctance by retailers to accept and pass on price promotions for branded products because of the presence of private labels.

The inquiry has heard confidential evidence that for some products the branded product can at times sell for less than the private label products. Furthermore, despite a loss of market share to private label products, a supplier told the inquiry that it does not feel that the presence of private label reduces competitive tension as the MSCs largely follow its recommendations regarding shelf space and promotional prices.

62 ibid., p. 54.
63 ibid., p. 55.
64 ibid., p. 61.
65 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 59.

In contrast to this evidence, the AHBIC told the inquiry[66]:

> Discounts have often been offered to the MSCs on branded products to lower the price to consumers in an attempt to increase sales of a particular product line, however, there is no guarantee that the discount is actually passed on to consumers. There have been numerous instances of product discounts being pocketed by the MSCs with no effect on the shelf price.

Confidential evidence presented to this inquiry suggests that a desire to protect sales of private labels does sometimes lead a retailer to maintain branded prices despite the suppliers' wish to price more competitively through the provision of additional promotional payments. However, this evidence is not necessarily inconsistent with the MSCs' position that not every promotional proposition that is put to them is accepted.

ACCC's view

The ACCC accepts that as retail shelf space is finite, the introduction of a new product, whether a proprietary or private brand, is likely to lead to the deletion of an existing product (the alternative being less shelf space being made available for an existing product). The ACCC has heard considerable evidence about the deletion process and has considered carefully whether the evidence shows that this process differs when the new product is a private label rather than a proprietary brand.

The ACCC understands that suppliers are concerned about the possible deletion of their products given the importance of the retail grocery channel to their sales. The evidence indicates that products most at risk of deletion are second and third tier brands. Further, underperformance is one of the main reasons that products are deleted. This suggests that some products that are deleted to make way for private label products are already under competitive pressure from existing rivals and may well have been deleted regardless of the existence or otherwise of a competing private label. In such cases, the ACCC considers that new private label products may increase competition within a category by offering a stronger rival to remaining brands in a category.

The ACCC considers that in many cases the introduction of a private label product priced below a comparable quality proprietary branded product is a source of price competition. In this regard, the introduction of private label products can be pro-competitive. Nevertheless, the ACCC considers that price competition would be distorted if retailers have reduced incentives to pass through to retail prices the competitive responses of branded product suppliers because of the growth of private labels.

On the evidence available, the positive aspects of private label products appear to be clearly present whereas the evidence of price distortion within a category was not strong.

16.8.3 Product innovation

Another concern put to this inquiry is the potential impact of growth in private labels on product innovation. Research and development costs associated with new product innovation are high and fixed. Producers undertake such investments if the expected returns are sufficiently high. The theoretical concern is that if private label sales increase at the expense of branded products, suppliers of branded products may have lesser incentive and ability to undertake new product innovation as expected returns would be lower.

For products that are not protected by proprietary technology or intellectual property laws, the length of time before rivals can copy successful new products (and thus compete away the profits from such products) has a direct impact on producers' incentives to engage in new product research and

66 AHBIC, submission no. 59, p. 10.

development. If the dissipation of rewards is made faster by the introduction of private label products, incentives for product innovation could be altered. This could ultimately lead to reduced innovation and fewer new products.

The inquiry has been told that suppliers typically share their new product plans with MSCs at annual reviews. This may give MSCs a head start in being able to copy those products compared with other rivals. However, suppliers have not raised concerns about the competitive effect of the requirement to share new product plans in advance with MSCs, nor has the inquiry heard evidence that suppliers have reduced their product innovation as a consequence.

Rather, manufacturers of proprietary brands could choose to respond to the threat of private labels by undertaking more innovation in order to further differentiate their offering from that of the private label. Thus, rather than blunting incentives to innovate, private labels may, in fact, promote product innovation. Indeed the inquiry was told by a supplier that one way to combat the advent of private labels is to be innovative and move into different spaces.

In addition, Coles told the inquiry that it will continue to develop and expand its private label range, reflecting the need to continually provide innovative and price competitive products to meet customer demand and to respond to changing product offerings of Coles' competitors.[67] This suggests that retailers themselves can be sources of product innovation. The Woolworths' Organic and Freefrom private label products may reflect this trend.

On the basis of the evidence presented to this inquiry, the ACCC does not consider that the introduction and growth of private label products raises widespread concerns about product innovation.

16.8.4 Copycat packaging

The inquiry has heard evidence from the AHBIC that MSCs are employing similar or copycat packaging and are engaging in branding practices designed to persuade consumers that their own label product is high quality.[68] As this is the extent of the evidence presented to this inquiry on the topic, the ACCC considers that copycat packaging of private label products is not of widespread concern.

16.9 Conclusions

The ACCC considers that the introduction of a private label product at a lower price point to existing comparable proprietary brands offers consumers additional choice and is pro-competitive, all other things being equal. Indeed, much of the evidence presented to the inquiry on this point shows that suppliers of rival branded products typically react competitively to the introduction of private label products. This reaction has led to lower retail prices in some categories.

However, the ACCC recognises that retailers have incentives to:

- promote their own labels in preference to proprietary brands by giving them preferential shelf space, including deleting branded products that are less profitable than the private label product
- retain additional promotional benefits obtained from branded suppliers in response to competition from private labels rather than passing those benefits to consumers in the form of lower retail prices.

67 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 5.

68 AHBIC, submission no. 59, p. 9.

However, the ACCC considers that to remain competitive, retailers must continue to deliver products that consumers value, or risk seeing their customers shop at other stores. The deletion of proprietary brands that consumers prefer in favour of private labels is unlikely to be in the long-term interests of the MSCs.

The inquiry has heard evidence indicting that MSCs generally accept increased promotional funding and pass through the funding to retail prices, although in limited circumstances this funding had been declined. The ACCC notes that there are risks of breaching s. 46 of the Act if promotional funding from a rival supplier of a proprietary brand is rejected in order to protect a private label product. Section 46 of the Act is directed at preventing firms with substantial market power from taking advantage of that market power for the purpose of eliminating or substantially damaging a competitor, preventing market entry or deterring or preventing competitive conduct in a market.

On balance, the evidence suggests that for many products, brands are important to the majority of Australian consumers. This loyalty provides some protection for proprietary brands from the competitive threat of private label products. Nevertheless, the evidence indicates that in most instances the introduction of a private label product leads to a competitive response from rival proprietary product(s), often in the form of increased promotional activity aimed at reducing the retail price of the proprietary branded product. ACCC does not consider that the growth of private label brands by the MSCs or other retailers raises significant competition concerns at this time or, importantly, that this growth is inconsistent with consumer preferences.

17 Conclusions on supply chains, buyer power and vertical relationships

Key points

The ACCC conclusions are:

- The ACCC is largely satisfied most categories of products are subject to adequate competitive pressure at each level of the supply chain.
- Movements in retail prices broadly reflect increases in costs and prices in other parts of the chain and for the most part the prices paid to producers as a proportion of the final retail price have not reduced significantly over time.
- Market concentration does deliver to the major supermarket chains (MSCs) and Metcash a substantial amount of buyer power in packaged groceries, which they use to improve price and non-price terms of supply. This buyer power does not appear to result in inefficient outcomes and uncompetitive pricing, and can in some circumstances benefit consumers.

17.1 Introduction

The preceding six chapters addressed three questions concerning the vertical supply chain for standard groceries:

- Is there sufficient competition at each stage of the supply chain to deliver grocery products at competitive prices to consumers?
- Do retail prices reflect prices paid for goods at other levels in the vertical chain, or is there an expanding gap between the prices paid to producers and the prices charged by retailers?
- Does the buyer power afforded to the MSCs and Metcash because of market concentration at the retail and wholesaling level result in inefficient outcomes or uncompetitive pricing of grocery products through the supply chain?

This chapter contains the ACCC's conclusions on the efficiency of supply chains, market power and vertical relationships. In broad terms the ACCC is satisfied that:

- Tthere is competition at each stage of the supply chain, with competition strongest at the primary producer level.
- There is no general trend of an increasing gap between prices paid to producers and prices charged by retailers.
- Market concentration does deliver to the MSCs and Metcash a substantial amount of buyer power. This buyer power does not appear to result in inefficient outcomes and uncompetitive pricing, and can in some circumstances benefit consumers.

17.2 Horizontal competition through the supply chain

In considering whether there is adequate horizontal competition through the grocery supply chain, the ACCC has examined supply chains for various food and non-food items. While each supply chain had different characteristics, a number of elements were common.

17.2.1 Producer level

Primary producers, including farmers, graziers and growers, sit at the start of many supply chains. Markets for the supply of primary products are highly competitive. They are characterised by large numbers of sellers and low barriers to entry. The prices in these markets fluctuate with domestic, and in many cases international, supply and demand.

When the market is oversupplied, prices will decline. When supply is short, prices can move up sharply. These markets can be subject to supply shortages for a variety of reasons. In the last eighteen months the best example of shortage of supply is wheat, which rose from $192 per tonne in 2005–06 to a forecast of $440 per tonne in 2007–08.[1] This was driven by a worldwide shortage of grain and strong increases in demand.

Other products exhibiting sudden surges in recent years include raw milk, for which the farm gate price has moved from 33c per litre to 48c per litre in the past 12 months, and Cavendish bananas, for which the wholesale price, following cyclone Larry, increased from $2.18 per kilo to a peak of $12.23 per kilo in the space of five months.[2]

These price increases reflect the operation of workably competitive markets. The ACCC has no concerns that these price changes represent a competition problem at this level of the market, but rather reflect international prices and supply-and-demand factors.

17.2.2 Wholesale level

Prices at the wholesale level need to be considered from two perspectives:

- the price paid to primary producers
- the price obtained when product is on-sold to retailers.

Prices to primary producers

The wholesale level of the supply chain in all products involves considerably fewer participants than the producer level.

For products traded internationally, such as wheat, this narrowing did not raise any concerns.

However, for products such as red meat, milk and fruit and vegetables, producers have expressed concerns that their options for sale were narrow and that the prices they receive for their produce may not be a true product of market forces. Accordingly, the ACCC examined several of these supply chains to determine whether they operated competitively.

For red meat, because of the relatively small number of wholesale buyers (including the MSCs, abattoirs and meat processors) and given the narrow specifications set for livestock sold onto the domestic market (making the MSCs a larger purchaser of that type of product than generally might be the case), a competition problem at this level could be possible. However, there are many features of the market that give the ACCC confidence that any competition problems are isolated.

First, Woolworths, the largest buyer, only buys 6 per cent of domestic production. Second, pricing evidence suggests that margins in processing are already low and that processors have offset recent increases in their costs of production with efficiency gains rather than passing through higher prices up the supply chain. Third, the MSCs are involved in the supply chain back to the farm gate. The

1 Australian Bureau of Agricultural and Resource Economics (ABARE), *Australian commodities*, March 2008, p. 33.

2 Wholesale price data purchased from Ausmarket.

retail gross margins the MSCs report on meat are relatively low and there is no evidence of a trend of such margins increasing. This suggests that involvement down the supply chain does not provide the MSCs with access to higher margins that would otherwise be earned at the processor level. Fourth, in percentage terms over the last decade, farm gate beef prices rose by more than the retail price, and for most of the last decade price increases at the retail level have fluctuated in line with wholesale prices. This suggests that processor and retailer margins are not expanding. As such, the ACCC does not consider it likely either processors or retailers are exercising substantial market power.

In relation to milk, the ACCC is satisfied that the number of dairy processors available in Australia result in a workably competitive market. While not every dairy farmer has access to every processor, the ability to transport fresh or processed milk domestically and internationally has the result that farm gate prices in south-east Australia[3] broadly reflect the prevailing international price of milk. In other parts of the country, where raw milk is not processed for export, farm gate prices are primarily set on the basis of local supply and demand.

For fruit and vegetables, a reasonable range of options appear to be available to a grower to sell their produce so that any price received will broadly reflect the conditions in the marketplace. Growers may sell their produce through a wholesaler operating in one of the wholesale markets, a growers' shed in the wholesale markets, directly to an MSC or to one of their consolidators, or directly to an independent retailer. The ACCC notes, however, that not all alternatives will be available to all growers.

In light of these findings, the ACCC is satisfied that as a general rule there is adequate competition for produce at the wholesale level and the prices paid to producers broadly reflect the operation of a competitive market.

Prices obtained when products are on-sold to retailers or Metcash

Retailers obtain products through a number of different channels.

Sales of packaged groceries and non-food items primarily occur through direct dealings between manufacturers and the MSCs or Metcash. As there are no wholesale markets for manufactured products, these negotiations are strongly influenced by retailer expectations and consumer reactions to the products themselves. Regular product reviews and intense trading term negotiations between the MSCs and suppliers appear to result in supply of product to the MSCs and Metcash on terms that reflect the scarcity of retail shelf space and the level of competition from other brands in the category. The ACCC is satisfied that this aspect of the market is generally competitive.

For products like fruit and vegetables, dealings can be directly between retailer and grower or between grower and a third party buying on behalf of a retailer. In the case of independent retailers, it is more common for the retailer to approach a wholesaler or to attend the wholesale markets to obtain their fresh produce. Consequently, the price of produce in the wholesale markets influences the pricing of products to all retailers. Prices achieved in the central markets are published regularly and are available to any interested party. Some operators in the market have their own sources of market intelligence which they use to determine the prevailing price in the market. The prevailing price strongly influences any direct negotiation between a grower and the MSCs and supply prices broadly reflect market conditions.

Products like milk and eggs are often obtained by a retailer through direct dealings with the producer or processor. Independent retailers usually obtain such products from Metcash. Prices for these products, including those sold under house-brands, are set following competitive tender processes in which

3 South-east Australia produces around 80 per cent of domestic milk production.

various suppliers compete. These processes produce extremely competitive supply prices to the MSCs in particular.

Prices for branded products are set following negotiation between retailer and producer or processor. Generally, the supplier will have a list price that is available to all purchasers. However, most retailers will negotiate discounts or rebates off the list price, with larger buyers usually receiving the most favourable terms. This reflects the volumes purchased by these buyers and the importance to the supplier of securing shelf space with large retailers.

The ACCC is satisfied that the market at this level is competitive.

17.2.3 Retail level

The competitiveness of retail pricing is the subject of analysis in the first part of this report and its analysis will not be repeated here.

It is sufficient to say that, generally speaking, it is at the retail level where price competition appears to be the least vigorous when compared to competition at other levels of the supply chain.

17.2.4 ACCC view on whether farm gate prices reflect retail prices

An analysis of pricing through the supply chain and, in particular, pricing at the farm gate and retail levels was completed in chapter 13 of this report.

The evidence presented in chapter 13 suggests that, contrary to popular belief, retail prices are not rising faster than farm gate prices in many grocery categories. A significant number of submissions received by the ACCC were concerned about such a phenomenon in fresh fruit and vegetables. As demonstrated in chapter 13, movements in the retail prices of eight key fruit and vegetables are largely in line with movements occurring in the wholesale markets as a result of supply-and-demand dynamics. Given that the MSCs' internal documentation shows that gross margins in the produce category have declined overall since 2002–03, it appears that the public's concern that retailers are stretching their margins is unfounded.

For milk, eggs, beef, chicken and apples, there were some periods where margins between farm gate/wholesale and retail prices stretched, but on other occasions those margins shrank.

The ACCC further notes that comparing farm gate prices with retail prices of some products is difficult and not necessarily instructive, given the level of processing that occurs after the product leaves the primary producer. For these products, given the high proportion that the cost of processing is to the end retail price, changes in farm gate prices may show very little correlation with the prices paid at the retail level. For example, the cost of wheat is only around 10 per cent of the cost of producing a loaf of bread. It would not be expected that changes in wheat prices would significantly affect retail bread prices.

The ACCC is satisfied that as a general rule, where the farm gate price is a significant proportion of the cost of producing the product, farm gate price movements over time are reflected in retail price movements.

17.2.5 ACCC's view on buyer power

There are many circumstances and many product categories in which the MSCs enjoy significant buyer power. However, the extent to which they have such power is not purely a function of their size or market dominance, but is most often a reflection of the outside options available to the party with which they are negotiating.

Packaged groceries

It is in the area of packaged groceries where the MSCs have the most buyer power. The power is a result of the size of their retail market share (which on a reasonable estimate is around 70 per cent of national sales in this category), the weakness of price competition from competitors, who generally source their packaged groceries through Metcash, and the lack of alternative sales channels available to suppliers.

Consequently, if a supplier wishes to distribute packaged groceries to a mass market in Australia, it is extremely important that it secures shelf space in at least one of the MSCs. As discussed in chapter 11 of this report, shelf space is a highly valued commodity in the grocery retail industry. The retailers' limited shelf space means that retailers are continually looking to range products that provide the greatest return to them (i.e. providing higher margins and higher sales) in order to maximise their profits. Accordingly, manufacturers have to deliver products that can be marketed at a retail price which is attractive to customers while providing retailers with the kind of returns it expects from the category. To be introduced to and sustained within a supermarket's range, a product must deliver superior price and non-price attributes to the products it competes with for scarce shelf space.

Unless a supplier of a product has a powerful brand (or is able to build such a brand) which the MSCs perceive as important to a category, the terms that can be negotiated with the MSC will tend to favour the MSC and from the supplier's perspective may erode over time. This broad, but not universal, trend is reflected in the ACCC's analysis of supply terms over time.[4] Further, in some cases, the MSCs were able to shift costs to suppliers and effectively unilaterally alter the terms on which goods are supplied, even after delivery.

The ACCC considers that this is a consequence of lack of real alternatives for the supplier in these instances.

Is this a significant problem?

Obviously, this bargaining weakness is a problem for the particular companies concerned, but not necessarily for consumers or the Australian community more generally. The risk associated with buyer power is that the companies which possess it will drive down prices in a way that discourages innovation or reduces competition at the supplier level. Neither of these effects is apparent in the Australian market at present. In addition, many of the companies that dominate this sector of the market are large multi-nationals with strong brands that often have significant consumer loyalty. Buyer power, particularly when increased by the use of private label products, may drive down margins and retail prices on branded products to the benefit of consumers.

Fresh produce

The buyer power of the MSCs in their fruit and vegetable transactions appears to be less than in packaged groceries. The ACCC considers that this is to be expected given the current market structure.

Growers and producers have significant outside options in the form of the central markets, direct supply to customers and export channels. It is the extent to which a grower has developed these outside options that appears to influence the outcomes they achieve.

4 See chapter 15 of this report for further analysis about supply terms.

Interestingly, as discussed in chapter 15 of this report, it is growers who generally have less of their business committed to supplying MSCs, who, on the face of it, receive better terms from the MSCs. A possible explanation for this is that growers who have geared their business model to the requirements of the MSCs may be more vulnerable in negotiations. The ACCC has received evidence that suggests that growers who have failed to develop alternative options to the MSCs are extremely vulnerable to the price pressure that appears to be routinely applied by the MSCs. As a result, growers with more developed outside options, no matter what their size, are more likely to negotiate more advantageous terms with the MSCs.

Is this a significant problem?

The MSCs' ability to pressure growers on terms of supply is a problem for growers who have failed to develop alternatives to dealing with the MSCs. However, well-structured growing businesses appear to deliver returns that make the business viable and profitable in the long term. There does not appear to be a case for any kind of regulatory intervention to alter the way in which the market operates. Indeed, there was very little complaint from MSC suppliers summonsed to give evidence. In many cases suppliers expressed satisfaction with the conduct of the MSCs.[5] In particular, the MSCs were reported to have been supportive of new, capital intensive products, such as packaged salads, and were able to assist the development of new or struggling businesses by underwriting volumes.[6] Growers who were updating their processes in an attempt to obtain greater efficiency seemed to get real benefits from dealing with the MSCs.

The issue of manipulation of wholesale markets was raised with the ACCC in the context of avocado supply, but on the evidence available it was impossible to draw any meaningful conclusions about whether this was occurring.

Dairy

There is no doubt that the MSCs are able to exercise considerable buyer power in the context of the contracts for the provision of house brand milk. The contracts are fiercely contested and the supply terms in some cases appear to be below cost. The remainder of the dairy range is also strongly competitive, but competition is not as vigorous as it is in the provision of private label milk.

Is this a significant problem?

This does not appear to be a problem for consumers and has probably resulted in cheaper milk than would be available in a less concentrated retail market. The price of private label milk appears to shift margin away from processors, and the benefit of that lower margin is shared between consumers and the MSCs. Accordingly, the change in the pricing structure brought about by the MSCs' buyer power appears to have benefited consumers, but has not resulted in any reduction to the farm-gate price. It is the dairy processors who appear to have suffered a decline in margin as a consequence of the MSCs' buyer power. A more competitive retail market, while likely to mean that the MSCs would have less buyer power, may, however, result in more of the benefit of any buyer power being passed on to consumers.

Beef, chicken and other meat

As a substantial buyer of meat, and in particular yearling heifers and steers primarily grown for domestic consumption, the MSCs' buying behaviour can influence price.

5 ACCC, public hearing transcript, Adelaide, 28 April 2008, p. 75.

6 ACCC, public hearing transcript, Hobart, 10 April 2008, p. 26.

However, given the medium-term option for graziers to switch cattle production to export, and the size of the export market as percentage of Australian beef production (approximately 65 per cent of domestically produced beef is exported), it is difficult to accept that the MSCs are manipulating the market to push prices below the cost of production.

The current low prices for beef relative to their costs of production appear to be the result of oversupply, which may be caused in part by the high Australian dollar. Accordingly, buyer power is not the root cause of low farm gate prices and, while there were many submissions that urged such a finding, there was no coherent explanation of how this was possible given the current market structure.

For chicken—the size of chicken producers and outside options available to them make it unlikely that they are the victims of buyer power; certainly there were no complaints to the inquiry to that effect.

The low price of bacon and ham was also raised with the inquiry, but it appears to have been influenced primarily by international factors rather any power on the part of the MSCs.

Is there a market power problem?

Looking at red meat, where the MSCs have the most influence in the supply chain, the ACCC does not consider that there is evidence of any benefit from competitive weakness in the supply chain accruing to the MSCs.

Retail margins in meat are low. In the case of the two MSCs, on the basis of information the ACCC obtained about the margins achieved in the category and information concerning the MSCs' overall cost of doing business, retailing meat contributes little to the bottom-line profitability of supermarkets. If there are beneficiaries from some distortion in the supply chain, there is no evidence that it is the MSCs.

In relation to participants at the processor level, it seems unlikely that they are able to manipulate the market to any significant degree. The evidence suggests that the gap between farm gate and wholesale pricing is low. There are players within the market who switch supply between the export and domestic market depending on market opportunities.[7] This suggests that international factors influence returns and that there are no above average returns to be made from supplying the Australian domestic market.

17.2.6 Buyer power and the consumer

The ACCC is not persuaded that there is a significant buyer power problem in the retail chain that requires broad regulatory action to resolve.

The sheer size of the MSCs and their share of sales in some categories obviously deliver to them a significant amount of bargaining power in many transactions and there are suppliers who are disappointed with the returns they receive when dealing with the MSCs.

However, there are also suppliers who are content with the terms they are able to obtain from the MSCs. Many are appreciative of the business opportunities that a deal with the MSCs provides to their business.

Accordingly, from the point of view of suppliers, no single picture emerges regarding the buyer power of the MSCs.

7 The ACCC understands that in particular meat processors and abattoirs may be able to take advantage of market opportunities in this way.

From a consumer's point of view, buyer power is generally only of concern if it is coupled with competitive weakness at the retail level. Such competitive weakness means that retailers do not have an incentive to pass on savings in the cost of goods to consumers.

As explained in chapter 10, the ACCC has concerns that while grocery retailing is workably competitive, there are currently factors that limit strong price competition and it is this aspect of the market where improvements can be made.

However, it should be highlighted that some aspects of the retail market do appear to be vigorously competitive. For example, in milk, private label prices have been lower as a consequence of the MSCs' buyer power and the benefits of those lower prices have been shared with consumers. Similar beneficial outcomes have been achieved for consumers in areas like generic eggs and bread. It is ultimately the individual consumer's choice as to whether they buy these lower priced private label products.

The ACCC's major concern rests with packaged groceries, particularly in brands that are not used by the MSCs to drive traffic. However, the most effective approach to these concerns is to lower barriers to entry, which would increase the likelihood of competitive entry or expansion of competitive retailers and a new wholesaler to compete with Metcash.

Accordingly, with the exception of changes to the Horticulture Code, which are addressed in chapter 18 of this report, the ACCC makes no specific recommendations to address the issue of buyer power. If steps to enhance competitiveness at the retail level are successful, it is likely that the retailers' buyer power will decrease and more likely that any benefits derived from remaining buyer power would be shared with consumers.

18 The Horticulture Code

Key points

That the following recommendations be considered by the Horticulture Code Committee:

- Amend the *Trade Practices Act 1974* (the Act) to introduce civil pecuniary penalties and infringement notices for a breach of a mandatory code made under Part IVB, such as the Horticulture Code, and to give the ACCC powers to facilitate the conduct of random record audits as an enforcement mechanism available under the code.
- Amend the Horticulture Code to regulate first point of sale transactions of horticulture produce between a grower and a retailer, exporter or processor.
- Amend the Horticulture Code to regulate first point of sale transactions between a grower and a trader in horticulture produce, including transactions entered into under agreements made prior to 15 December 2006.
- Amend the Horticulture Code to require a merchant to provide a grower, before delivery, with either a firm price or a formula for calculating price. Any agreed method used to calculate price must be by reference to the amount received by the merchant from the sale of the produce to a third-party purchaser.
- Amend the Horticulture Code to require that if a merchant does not reject the produce within 24 hours of physical delivery, the produce is deemed to be accepted.
- Amend the Horticulture Code to enable a merchant to deduct the cost of any services that are supplied to prepare the produce for resale as part of the price amount or as part of the method for calculating the price amount.
- Amend the Horticulture Code to only permit an agent to recover their commission for services performed under an agency agreement as a deduction from amounts paid by a third-party purchaser.
- Amend the Horticulture Code to exclude persons who may be an agent's competitor from inspecting that agent's records on a grower's behalf.
- Amend the Horticulture Code to ensure that transactions between a grower and a cooperative/packing house, in which that grower has a significant interest, are exempt from regulation under the Horticulture Code.
- Amend the Horticulture Code to permit agents and growers to engage in pooling and price averaging.
- Amend the Horticulture Code to exempt transactions entered into in a grower shed at the central markets from regulation under the code, while permitting parties to these transactions to access the code's dispute resolution procedure.
- That the costs incurred by the parties to a dispute under the Horticulture Code dispute resolution procedure be subsidised by the Australian Government to the same extent as they are under the voluntary Produce and Grocery Industry Code of Conduct (PGICC). That the ACCC undertake further education in relation to the Horticulture Code and its dispute resolution procedures, including the role of assessors in resolving disputes.

18.1 Introduction

One of the terms of reference of this inquiry includes an assessment of the effectiveness of the Horticulture Code of Conduct (the Horticulture Code) and whether the inclusion of other major buyers such as retailers, would improve the effectiveness of the code. The effectiveness of a prescribed industry code is typically assessed on the basis of how well the code has achieved its objectives.

The Horticulture Code's objectives are to:

- regulate trade in horticulture produce between growers and traders to ensure transparency and clarity of transactions (the code does not seek to regulate prices)
- provide a fair and equitable dispute resolution procedure for disputes arising under the code or a horticulture produce agreement.

18.2 Review of the Horticulture Code by the Horticulture Code Committee

The ACCC notes that when the Horticulture Code was first introduced it was intended that the code would be reviewed following a two-year implementation period, during which industry participants would need to adapt their business practices in order to bring about compliance with the code. In September 2007, approximately four-months after the commencement of the Horticulture Code, the then Minister for Agriculture, Fisheries and Forestry, the Hon. Peter McGauran, appointed the Horticulture Code Committee to commence deliberations on industry issues associated with the operation and performance of the code and to provide advice to the minister on the operation of the code.

As part of the review process the Horticulture Code Committee's role has been to develop and recommend practical options and actions that support the effective operation of the Horticulture Code and to consider whether such amendments will further the code's objectives, and also to consider the impact the amended code may have on individual sectors of the industry, including in relation to ongoing compliance costs.[1]

The Horticulture Code Committee has informed the industry of its outcomes through the distribution of media releases and meeting minutes following each meeting. The Horticulture Code Committee has also informed the minister of the outcomes of each meeting and will provide the minister with an annual report on its activities in terms of how it is addressing the terms of reference. The ACCC was also invited to attend and participate as an observer (with no voting or decision making rights) in the Horticulture Code Committee meetings. The ACCC's role on the Horticulture Code Committee has therefore been to provide general advice on Horticulture Code related issues and to answer questions on its role in bringing about compliance with the code.

18.3 The ACCC grocery inquiry

When the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs requested in January 2008 that the ACCC review the effectiveness of the Horticulture Code as part of the inquiry, a number of parties noted that the code had only been in place for 14 months. The Horticulture Code Committee, for example, commented that while the committee had already met twice to discuss these

1 Horticulture Code Committee, *Statement of outcomes*, 20 February 2008

very issues, this period of time had, 'not adequately allowed the committee to reach its own position or make recommendations to the minister'.[2]

It also commented that it would, following a third meeting, await the outcome of the inquiry before undertaking any further consideration of the Horticulture Code. The Produce and Grocery Industry Code Administration Committee[3] and the National Farmers Federation[4] also noted that it may be difficult to assess the effectiveness of the Horticulture Code at this early stage as the industry may not have had adequate opportunity to make the necessary adjustments to its business practices.

Avocados Australia mirrored these concerns in commenting that:

> the code probably needs five years and some tweaking. It does need some improvement, just ensuring that it meets what it was intended to meet going forward in that period. But when you are talking about a set of business practices that have existed for 50 or 100 years, you are not going to change it in 12 months. It's just not physically possible.[5]

While the ACCC has sought to address the industry's initial resistance to the Horticulture Code through a comprehensive education and liaison strategy (discussed further below), the ACCC is also aware that the introduction of the code imposed a significant cultural change within the horticulture industry. The introduction of any code of conduct can only be measured when the industry has had sufficient time to assess the changes, take measures to change operational procedures to address the code, bed down and refine the changes and, to gain industry wide acceptance. The introduction of the Franchising Code of Conduct, for example, was opposed by the key industry body for almost four years following its introduction. However, nearly a decade later a cultural change has taken place within the franchise sector whereby the peak body encourages compliance with the Franchising Code and supports continual improvement and training within its membership. The ACCC is therefore aware that the horticulture industry may also require a further period of adjustment in order to bring about the significant cultural and structural changes required by the Horticulture Code.

In order to adequately address the complex Horticulture Code issues that have been raised throughout the inquiry and to ensure that industry participants have had an opportunity to provide detailed comments on these issues, the ACCC published a second Horticulture Code issues paper. As a result, the ACCC has received and considered submissions in response to the more general issues paper and 28 submissions in response to the more specific Horticulture Code issues paper.

While a wide range of issues have been raised throughout the inquiry, the ACCC has identified and addressed the following key Horticulture Code issues in this chapter:

- industry compliance and the ACCC's enforcement of the code
- whether the code should be extended to include retailers, processors and exporters
- whether pre-existing contracts should continue to be exempt from regulation under the code
- the definition of 'delivery' and the shifting of ownership between parties
- the rights and obligations of agents under the code
- whether packing houses and cooperatives should be regulated by the code
- whether pooling and price averaging should be permitted by the code
- whether grower sheds should be regulated by the code
- the effectiveness of the code's dispute resolution procedure.

2 Horticulture Code Committee, submission no. 32, p. 2.
3 Produce and Grocery Industry Code Administration Committee submission no. 50, p. 4.
4 National Farmers Federation, submission no. 137, p. 15.
5 ACCC, public hearing transcript, Brisbane, 3 April 2008, p. 137.

Following consideration of these issues, it is the ACCC's view that the diversity and complexity of the horticulture industry cause it to be a difficult industry to regulate effectively without causing unintended side effects and incurring compliance costs. Nevertheless, the ACCC believes the Horticulture Code has merit and, if amended in accordance with the recommendations outlined below, the code has the potential to provide a framework which ensures transparency in transactions and fairness in dispute resolution procedures. The ACCC considers, however, that the inquiry is not the appropriate forum to redraft the Horticulture Code and proposes that the existing Horticulture Code Committee is better placed to further consider the recommendations outlined below with a view to providing the government with a more detailed analysis on how these recommendations may be implemented. The ACCC would also propose that a subsequent review of the Horticulture Code be undertaken in two or three years time to assess whether the code has brought about greater clarity and transparency throughout the industry and an accessible dispute resolution procedure.

The ACCC notes that many of the issues and concerns that ultimately led to the development of the Horticulture Code were initially raised by industry participants as part of the development of the Produce and Grocery Industry Code of Conduct. A brief discussion regarding the development and the proposed benefits of this voluntary code is therefore set out below.

18.4 The Produce and Grocery Industry Code of Conduct

On 10 December 1998 the federal parliament established the Joint Select Committee on the Retailing Sector to inquire into and report on the impact of market concentration in the retail sector and to recommend possible revenue-neutral courses of action for the Australian Government. On 30 August 1999 the Joint Select Committee on the Retailing Sector (later known as the Baird Inquiry) produced a report, *Fair market or market failure*? One of the committee's recommendations was the establishment of a mandatory code of conduct to regulate the retail grocery sector.[6]

On 17 December 1999 the Australian Government released its response to the report. It announced the development of a voluntary Retail Grocery Industry Code of Conduct (RGICC), full Government funding for a Retail Grocery Industry Ombudsman to assist in the resolution of industry disputes, and amendments to the Act to improve access by small businesses to remedies and damages.[7] However, the announcement was not without reservations. The minister also indicated that a mandatory code of conduct may still be adopted, 'if a review of developments indicate an unsatisfactory participation level'.[8]

Therefore, in accordance with the government's decision, an industry-funded committee comprising a cross-section of industry representatives was established on 13 February 2000 to develop the voluntary code of conduct for the produce and grocery industry. The committee developed and launched the RGICC on 13 September 2000.

A review of the RGICC was subsequently conducted in 2003 by an independent reviewer, Mr Neill Buck. The review, which concluded on 12 December 2003, found that while the RGICC had made some progress in addressing issues in the sector, the Code had 'not worked well enough to resolve some major issues in the retail grocery industry supply chain', and that this was, 'affecting the economic health and efficiency of the sector'. [9] The review therefore recommended that, 'a principles-

6 Joint Select Committee on the Retailing Sector, *Fair market or market failure—a review of Australia's retailing sector*, 1999, pp. xxii–xxiii, recommendation 5.

7 N Buck, *Report of the review of the Retail Grocery Industry Code of Conduct*, December 2003, p. 19.

8 The Hon. Peter Reith MP, Minister for Employment, Workplace Relations and Small Business, media release, 17 December 1999.

9 N Buck, *Report of the review of the Retail Grocery Industry Code of Conduct*, December 2003, pp. 12–13.

based code underpinned by regulation be implemented', in order to deal with a number of significant challenges in the sector.[10] Following the review, on 11 February 2005, the RGICC was renamed the PGICC and the administering body became the Produce and Grocery Industry Code Administration Committee (PGICAC). The federal Department of Agriculture, Fisheries and Forestry (DAFF) provides secretariat support for the PGICAC, manages the contract for the Produce and Grocery Industry Ombudsman (the PGIO) mediation service and runs the communications campaign for the PGICC.[11]

The PGICC provides a voluntary set of guidelines that aims to promote fair, open and equitable trading practices, and seeks to guide the conduct of businesses throughout their vertical transactions within the produce and grocery industry supply chain (which includes processors, wholesalers, distributors and retailers but not consumers). The PGICC also provides an accessible government-subsidised dispute resolution mechanism for industry participants through the PGIO mediation service.[12] While a number of key organisations and businesses have committed to promoting the PGICC and their own internal dispute resolution procedures, other organisations may also endorse the voluntary code.[13]

18.5 Introduction of the Horticulture Code

Supporters of the PGICC have argued against a mandatory code, stating that the voluntary code already provides industry participants with a government subsidised, voluntary system of mediation along with some guidance as to how businesses may conduct themselves with greater clarity and certainty.[14] However, some growers of horticulture produce and their representative associations continued to voice the concerns raised in the Buck report[15] and called for the implementation of a 'principles based code underpinned by regulation with simple disclosure and business practice provisions'[16]. In particular, those calling for a mandatory horticulture code of conduct argued that the existing voluntary PGICC code did not require signatories to enter into written contracts to evidence terms and conditions of supply, and did not enable one party to require another to participate in the mediation of a dispute.

To address these concerns, the government determined that the PGICC had failed to provide the industry with the transparency and certainty it required, and publicly committed itself to prescribe a mandatory industry code of conduct for the wholesale horticulture industry under s. 51AE of the Act.[17] On 1 October 2004 the then Deputy Prime Minister, the Hon. John Anderson, announced that a re-elected coalition government would introduce a mandatory Horticulture Code of Conduct that would 'aim at improving the transparency of trading transactions in the wholesale fresh fruit and vegetable sector'.[18]

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10 N Buck, *Report of the Review of the Retail Grocery Industry Code of Conduct*, December 2003, p. 14.

11 On 20 November 2006 the government transferred responsibility for administering the PGICC from the Office of Small Business in the federal Department of Industry, Tourism and Resources to DAFF.

12 The Produce and Grocery Industry Code Administration Committee, submission no. 50, p. 1.

13 The Produce and Grocery Industry Code Administration Committee, submission no. 50, p. 3; ALDI Stores; Australian Chamber of Fruit and Vegetable Industries Ltd; Australian Dairy Farmers; Australian Chicken Growers Council; Australian Egg Corporation Limited; Australian Food and Grocery Council; Australian Retailers Association; Coles Group Limited; Murray Valley Winegrape Growers; National Association of Retail Grocers of Australia; National Farmers Federation; National Retail Association; Horticulture Australia Council; Queensland Retail Traders and Shopkeepers Association; and Woolworths Limited.

14 Annexure to the Produce and Grocery Industry Code of Conduct.

15 N Buck, *Report of the review of the Retail Grocery Industry Code of Conduct*, presented to the Office of Small Business, Department of Industry, Tourism and Resources, Canberra, 2003.

16 Explanatory statement for the Horticulture Code of Conduct, Select Legislative Instrument 2006, no. 376 p. 1.

17 DAFF, *Horticulture Code of Conduct,* regulation impact statement, December 2006, p. 2.

18 Centre for International Economics, *Horticulture Code of Conduct,* draft regulation impact statement, July 2005, p. 1.

More specifically, the draft[19] and the final[20] regulation impact statement recommended that the Horticulture Code should seek to:

- regulate trade in horticulture produce between growers and traders to ensure clarity and transparency of transactions
- provide a fair and cost-effective dispute resolution procedure.

While a significant amount of data regarding the wholesale price of horticulture produce is generally available to industry participants, it is often argued by growers and grower associations that this data is subject to manipulation by market intermediaries.[21] In particular, wholesalers have generally sought to protect their interests by retaining confidentiality regarding their supplier and on-sale networks as well as market price information. Similarly, wholesalers have noted that they are often uncertain about the quality and quantity of produce that a grower will supply until the produce arrives at the marketplace.[22] This systemic lack of clarity and transparency in the wholesale market has led to information asymmetries between growers and traders.[23]

These problems have been exacerbated by the failure of industry participants to invest in written trade documentation, including written transaction information and written trading agreements.[24] Prior to the introduction of the Horticulture Code, much of the wholesale trade in horticulture produce was conducted on the strength of a verbal agreement between growers and wholesale traders.[25]

In the absence of clear and transparent written terms of trade or written contracts, many wholesale traders have sought to maximise their profits and minimise their risk in the marketplace by trading in accordance with the 'hybrid model'. The hybrid model does not require the trader to clarify with the grower whether the trader is operating as an agent or as a merchant in any particular transaction.

Accordingly, the hybrid system of trade creates uncertainty as to:

- When the transfer of ownership in the produce occurs. The hybrid model ensures that ownership and commercial risk in the produce resides with the grower until the produce is sold on to a third-party purchaser (in some cases the risk may remain with the grower until the third-party buyer accepts and on-sells the produce). In turn, the trader may pass any loss incurred as a result of produce being returned or rejected by the third-party purchaser, back onto the grower.[26]
- When and how the price for the produce is determined. Under the hybrid model, the trader will undertake to achieve 'the best price they can' for the grower in the market. While this appears to fit an agency model, the trader will trade as a 'merchant' and make a profit by on-selling the produce to a third-party purchaser, rather than charging a commission. The trader is therefore in a strong position to determine the price that the grower will receive for their produce after the trader has sold the produce onto a third-party buyer and subtracted the trader's profit or commission on that sale.

Some growers and grower associations also expressed concerns regarding the common industry practice of cost and price averaging. Some growers have argued that this practice 'simplifies transactions but also mutes price and cost signals, reducing incentives to maximise quality and creating

19 ibid., p. 3.
20 DAFF, *Horticulture Code of Conduct*, regulation impact statement*,* December 2006, p. 2.
21 S Spencer, *Price determination in the Australian food industry: a report*, DAFF, Canberra, 2004, p. 60.
22 Centre for International Economics, *Horticulture Code of Conduct,* draft regulation impact statement, July 2005, p. 26.
23 DAFF, *Horticulture Code of Conduct,* regulation impact statement, December 2006, p. 8.
24 ibid.
25 ibid., p. 3.
26 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. 14.

incentives which tolerate excess supply of low quality fruit [and vegetables]'[27], and further exposes growers to price-return risks, regardless of product quality.[28] In turn, wholesalers and central market chambers have argued that growers contribute to the uncertainty in wholesale markets by delivering unsolicited produce to traders and labelling produce of various grades and quality as 'A1'.[29]

In order for growers and traders to effectively resolve disputes that arise under their agreements and the Horticulture Code, the final regulation impact statement identified the need for an effective dispute resolution process, including an independent assessment of transactions and a mediation process.[30]

18.5.1 The Horticulture Code development and consultation process

The Department of Agriculture, Forestry and Fisheries, the policy agency responsible for the development of the Horticulture Code, retained the Centre for International Economics and Allens Arthur Robinson to assist in the development of a draft regulation impact statement and a draft Horticulture Code. These documents were released for public consultation in August 2005 and public forums were held in five capital cities[31] and three regional centres[32] to discuss the issues raised. The public consultation process also included an extensive number of meetings with individual growers, grower representatives, wholesalers at central wholesale markets, independent and major retailers, processors, packing sheds, state government representatives in every state and the Northern Territory, and Australian Government agencies such as the ACCC.[33]

In response to a call for written submissions on 24 August 2005, over 213 submissions were received on the draft code options. The draft code options were further developed in consultation with key representative groups, including the National Farmers Federation, Horticulture Australia Council, the Australian Chamber of Fruit and Vegetable Industries and the Central Markets Association of Australia. Six options were then considered in the final regulation impact statement cleared by the Office of Regulation Review.[34]

The preferred option was selected on the basis that it could facilitate—with lower compliance costs—improved clarity and transparency in transactions between growers and wholesale traders that would in turn raise trading standards in the horticulture industry and improve market efficiency.[35] A draft copy of the regulations was informally distributed to the industry in early December 2006.

His Excellency the Honourable Major General Michael Jeffery AC, CVO, MC (Retd), Governor-General of the Commonwealth of Australia signed the Trade Practices (Horticulture Code of Conduct) Regulations 2006 (Cwlth) on 13 December 2006, and registered the regulations on the Federal Register of Legislative Instruments on 15 December 2006. The regulations were tabled in federal parliament on 6 February 2007. The Horticulture Code therefore commenced as a prescribed mandatory industry code of conduct under s. 51AE of the Act on 14 May 2007. A primary role of the ACCC under s. 51AE of the Act is to administer mandatory industry codes of conduct that have been prescribed (i.e. made law) by the Australian Government. A prescribed mandatory industry code of conduct is binding on all

27 Centre for International Economics, *Horticulture Code of Conduct,* draft regulation impact statement, July 2005, p. 29.

28 S Spencer, *Price determination in the Australian food industry: a report*, DAFF, Canberra, 2004, p. 54.

29 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. 29.

30 DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 8.

31 Sydney, Hobart, Melbourne, Brisbane and Adelaide.

32 Atherton, Humpty Doo and Mildura.

33 Explanatory statement for the Horticulture Code of Conduct, Select Legislative Instrument 2006, no. 376, pp. 1–2.

34 Explanatory statement for the Horticulture Code of Conduct, Select Legislative Instrument 2006, no. 376, p. 2.

35 ibid.

industry participants. Section 51AD of the Act provides for the ACCC to take action against breaches of prescribed codes such as the Horticulture Code.

18.5.2 Current coverage of the Horticulture Code

The Horticulture Code regulates wholesale trade in horticulture produce.[36] Subject to certain exceptions, it applies to traders and growers who trade with each other in horticulture produce on and after 14 May 2007.[37]

Horticulture produce is defined in the Horticulture Code to mean unprocessed fruit, vegetables (including mushrooms and other edible fungi), nuts, herbs and other edible plants. [38] A grower is defined in the Horticulture Code as a person who grows their own horticulture produce for sale. A trader is defined as either an agent or a merchant. More specifically, a merchant is defined as a person who purchases horticulture produce from a grower for the purpose of reselling that produce, and an agent is defined as a person who sells horticulture produce on behalf of a grower to another person for a commission or fee. The Horticulture Code does not currently regulate those who purchase produce for the purpose of retail, processing or export.[39] As recommended in the draft and the final regulation impact statement, the Horticulture Code's objectives are to:

- regulate trade in horticulture produce between growers and traders to ensure transparency and clarity of transactions
- provide a fair and equitable dispute resolution procedure for disputes arising under the code or a horticulture produce agreement.

18.5.3 Current exemptions from regulation by the Horticulture Code

Retailers, processors and exporters

Both the draft[40] and the final[41] regulation impact statement, prepared before the commencement of the Horticulture Code, reported that supermarket retailers, exporters and processors provide growers with comparatively clear and transparent supply agreements. In particular, the draft regulation impact statement also noted that:

> supermarkets are likely to gain nothing from implementation of the code due to the fact that they are largely achieving the desired objectives of the code now but under voluntary codes of conduct[42].

In recognition of what was understood to be relatively clear and transparent retailer horticulture produce supply arrangements, the government exempted retailers from the Horticulture Code.[43]

36 Clause 2 of the Horticulture Code.

37 Regulation 3 of the Trade Practices (Horticulture Code of Conduct) Regulations 2006.

38 The term 'unprocessed' is not defined in the code. The meaning of unprocessed will be determined by the circumstances of each case. However, the ordinary meaning of unprocessed is produce that has not been converted, altered or modified in some way for the purpose of making it into a new form. Nursery products are not considered to be horticulture produce and trade in them is not regulated by the Horticulture Code. 'Nursery products' include trees, shrubs, plants, seeds, bulbs, corns and tubers (excluding edible tubers), propagating material and plants tissue cultures (grown for ornamental purpose or form producing fruits, vegetables, nuts or cut flowers and foliage), and cut flowers and foliage.

39 Clause 3 of the Horticulture Code.

40 Centre for International Economics, *Horticulture Code of Conduct*, draft regulation impact statement, July 2005, p. xix.

41 DAFF, *Horticulture Code of Conduct,* regulation impact statement*,* December 2006, p. 9.

42 Centre for International Economics, *Horticulture Code of Conduct,* draft regulation impact statement, July 2005, p. xviii.

43 ibid., pp. 17–19.

Existing written agreements

The Horticulture Code came into effect on 14 May 2007 and automatically applied to horticulture trade that occurred on or after that date. However, if a grower or trader has a written agreement that was entered into prior to 15 December 2006 (the date the code was registered on the Federal Registrar of Legislative Instruments), the Horticulture Code does not apply to those transactions. If a grower or trader varies the agreement on or after 14 May 2007, the Horticulture Code will automatically apply to trade that takes place under that agreement from the date of variation. Any written agreement that was entered into after 15 December 2006, but before the Horticulture Code commenced on 14 May 2007, is subject to the code from 14 May 2007.

Limitations on coverage under the Act

It is important to note that the Act, and therefore the Horticulture Code, regulates corporations, trade across state borders and trade within a territory (i.e. the Australian Capital Territory and Northern Territory). While the Horticulture Code does apply to unincorporated bodies where the wholesaler and respective grower are in different states and/or territories or within the same territory, the Horticulture Code does not apply to unincorporated bodies where the wholesaler and the respective grower are within the same state and both grower and trader are unincorporated. However, if one of the parties to the transaction is incorporated, it is the ACCC's view that the Horticulture Code applies. It is estimated that a high proportion of wholesale horticulture trade occurs across state borders and around 50 per cent of wholesaling businesses are incorporated.[44]

Potato marketing schemes

The Horticulture Code does not apply to growers and traders already trading under a statutory potato marketing scheme. A statutory potato marketing scheme is a state or territory scheme that regulates the marketing, sale or disposal of unprocessed potatoes.

18.5.4 Key obligations under the Horticulture Code

The Horticulture Code requires that traders and growers comply with certain obligations. These obligations are summarised below.

Trader's terms of trade

The Horticulture Code requires that a trader must prepare, publish and make publicly available a document setting out the terms and conditions under which they are prepared to trade in horticulture produce with growers. This document is called a trader's terms of trade. A trader must give a copy of their terms of trade to any grower who asks for them.[45] The Horticulture Code specifies that a trader's terms of trade must comply with the code and contain certain specific information.[46]

44 DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 2.

45 Clause 4 of the Horticulture Code.

46 Clause 5 of the Horticulture Code.

Horticulture produce agreements

The Horticulture Code requires that a trader and a grower can only trade in horticulture produce with each other if they have entered into a horticulture produce agreement that complies with the Horticulture Code.[47] A horticulture produce agreement must be in writing, signed by the parties to it, and cover specific matters required by the Horticulture Code.[48]

Trader's responsibilities

In addition to requiring a terms of trade document and horticulture produce agreements, the Horticulture Code places further obligations on all traders, both agents and merchants, as well as specific obligations for agents and specific obligations for merchants.

Dispute resolution procedure under the Horticulture Code

Part 5 of the Horticulture Code provides that growers and traders may use any dispute resolution procedure they choose to resolve horticulture disputes that arise between them. However, if a grower or trader (the complainant) initiates a dispute under the dispute resolution process set out in the Horticulture Code, the other party (the respondent) must participate in that process as required by the code.[49]

The Horticulture Code mediation adviser (the mediation adviser) has been established to assist industry participants to resolve disputes and, on request, appoint mediators from a specialist panel of experienced mediators across Australia. Part 6 of the Horticulture Code also provides growers and traders with access to horticulture produce assessors. Horticulture produce assessors are individuals that have been selected by the mediation adviser as having the necessary technical skills and independence to investigate and provide a report on any matter arising under a horticulture produce agreement.

18.5.5 Compliance and enforcement of the Horticulture Code

The ACCC plays an important role in promoting compliance with the Horticulture Code and the Act. It achieves this through education, providing access to information, and, where necessary, enforcement action.

In particular, the ACCC:

- administers s. 51AD of the Act, which prohibits contraventions by corporations and by individuals of applicable industry codes (e.g. the Horticulture Code)
- administers s. 51AC of the Act, which allows courts to determine unconscionable conduct in a particular case with regard to the requirements of any applicable industry code (e.g. the Horticulture Code)
- promotes compliance with the law by educating industry participants about their rights and obligations under the Horticulture Code
- enforces the provisions of the Horticulture Code where necessary by seeking remedies available under the Act
- enforces all other relevant provisions of the Act.

47 Clause 6 of the Horticulture Code.
48 Clause 9 of the Horticulture Code.
49 Clause 30 of the Horticulture Code.

- To promote compliance with the Horticulture Code, the ACCC has developed and distributed the following compliance materials:
- *An overview of the Horticulture Code*—an A4 double-sided information sheet that summarises the Horticulture Code in plain language.
- *The guide to the Horticulture Code for growers and wholesale traders in the horticulture industry*—an A5 booklet summarising the Horticulture Code in plain language.
- *The Horticulture Code—how does it affect you?* (DVD)—an educational DVD outlining the key parts of the Horticulture Code.
- *The Horticulture Code compliance manual*—a plain language manual aimed at providing stakeholders with guidance on how to comply with the Horticulture Code and establish an effective compliance program. The manual contains information flow charts and checklists, and a CD containing template documents.
- *Horticulture Code—questions and answers*—answers to the most common questions regarding the Horticulture Code.
- *Horticulture Code fact sheets*—A4 double-sided information sheets on the following specific topics:
  - *Does the Horticulture Code apply to packing houses?*
  - *What to do if you receive horticulture produce without a horticulture produce agreement*
  - *Why say NO to backdated horticulture produce agreements*
  - *Can growers collectively bargain?*
  - *What are a merchant's rights and responsibilities under the Horticulture Code?*
  - *What are an agent's rights and responsibilities under the Horticulture Code?*
  - *What is unprocessed horticulture produce?*
  - *Service agreements and complying with the Horticulture Code.*

The ACCC also created an information network for stakeholders in the horticulture industry, to provide them with timely information about compliance with the Horticulture Code. The ACCC currently has 611 subscribers, including representatives from grower and wholesaler associations, and the federal government and state governments.

While the Horticulture Code committee acknowledged, 'the work that the ACCC has carried out in educating and communicating to industry about the code and judges that there is sufficient information available about the code'[50], grower associations have argued that more needs to be done to bring about compliance with the Horticulture Code.

The NSW Farmers Association noted, for example, that, according to a survey conducted in February 2008, of 24 of its horticulture producers:

- 79 per cent had a trading relationship that required an agreement
- 32 per cent had not discussed the matter with the agent/merchant
- 21 per cent were trading without an agreement
- 58 per cent did not know if their agreement was compliant with the code.[51]

50 Horticulture Code Committee, submission no. 32, p. 3.

51 NSW Farmers Association, submission no. 155, p. 21.

The ACCC also heard evidence from a wide range of parties, including Horticulture Australia Ltd, AUSVEG Ltd and Grow South Australia (Grow SA), that the ACCC has not undertaken sufficient enforcement of the Horticulture Code to bring about compliance throughout the industry. Horticulture Australia Ltd, for example, commented that:

> In relation to the [Horticulture Code], industry organisations and grower advocates acknowledge that there are many examples where the introduction and compliance with the code has resulted in successful business relationships between growers and traders as defined by the code. However there is a substantial groundswell of dissatisfaction being expressed by these bodies about the level of non-compliance from traders, the tactics utilised by many traders to avoid complying with the code, and the will and ability of the ACCC to enforce the code and understand the commercial dynamics between these two traditionally disparate thinking groups.[52]

While the central market chambers have not sought further enforcement of the Horticulture Code, the New South Wales Chamber of Fruit and Vegetable Industries Inc. commented that, 'The other reason that the code is not impacting on business is because many within the industry are simply ignoring it.'[53]

In fact, the NSW chamber argued that it is growers rather than traders that are refusing to enter into compliant agreements and explained that:

> The traders involved are attempting to comply with the code yet the growers are not signing the documents and returning them to the trader. Their reluctance to do so is placing the traders in a less than ideal situation as they cannot trade with the grower without an agreement in place. Yet the growers in many instances continue to send their produce in to the trader knowing that they are in breach of the code.[54]

Since the commencement of the Horticulture Code, the ACCC has only received a small number of substantive complaints alleging non-compliance with the Horticulture Code. While the central market chambers argued that this is largely due to growers' disinterest in the code, grower groups have argued that growers are reluctant to provide the ACCC with adequate complaint details regarding alleged breaches of the Horticulture Code because of concerns that growers will in turn be singled out by disgruntled traders and subjected to harassment and/or commercial ruin.

The Horticulture Australia Council noted, for example, that its recent survey indicates that 85 per cent of its members agreed that growers were often unwilling to raise issues with major retailers and wholesalers for fear of retribution.[55] Similarly, Ms Sue Brigendi, a packer of horticulture produce, explained that even if the marketer, for example, does not comply with their agreement with the grower, there is little the grower can do about it:

> … there's not many growers that will take on a marketer, especially a large marketer. They can't afford to. It's a small industry and you can't afford to get people offside because you'd be branded a troublemaker.[56]

Grow SA also acknowledged that growers fear potential:

> …punitive behaviour designed to enforce desired behaviours by suppliers (e.g. issues associated with 'being made to take a holiday' and return of product). There is a fear of retaliation/victimisation amongst growers.[57]

52 Horticulture Australia Council, submission no. 92, p. 106.

53 New South Wales Chamber of Fruit and Vegetable Industries Inc., submission no. 99, p. 5.

54 The Chamber of Fruit and Vegetables Industries in Western Australia Inc., Horticulture Code issues paper submission no. 5, p. 3.

55 Horticulture Australia Council, submission no. 63, p. 5. The ACCC notes that the council did not provide the sample size for this survey.

56 ACCC, public hearing transcript, Griffith, 8 April 2008, p. 20.

57 Grow SA, submission no. 112, p. 8.

Grow SA also commented that:

> There are also examples of growers being "black listed" by all wholesalers in one or more of the central markets if they attempted to negotiate a compliant agreement, or raise issues or complaints with the ACCC.[58]

While similar concerns exist in other industries, the ACCC is aware that growers of horticulture produce may rely on an expectation that they will remain in the industry for the long term and any damage to their ability to continue to participate in the industry would cause significant harm. The ACCC is also aware that growers who have non-compliant trading arrangements may not wish to bring these matters to the attention of the ACCC out of fear that they may also be prosecuted. Unfortunately, growers' reluctance to provide substantiated complaints to the ACCC has only further inhibited the ACCC's ability to take effective enforcement action and bring about compliance with the Horticulture Code.

It is also apparent that a significant proportion of the horticulture industry currently trades under agreements entered into prior to 15 December 2006 that are not required to comply with the Horticulture Code. The lack of clarity regarding how these agreements were entered into, and which parties have entered into such exempt agreements, poses additional challenges to the effective enforcement of the Horticulture Code. This issue is addressed in more detail below.

Grower associations have also suggested that the ACCC may lack the necessary enforcement tools to address the mischief that the Horticulture Code seeks to remedy. Grow SA for example submitted that:

> Feedback commonly received is that the code has no strength or impact as there has been no enforcement or any penalties associated with doing the wrong thing.[59]

Grow SA also commented that:

> The only way recalcitrant players will be brought into compliance is through a real threat of punishment. Thus the code must be not only enforced appropriately by the ACCC - but it must be seen to be enforced.[60]

The South Australian Farmers Federation also supported the call for mandatory industry codes of conduct to be enforced with stronger penalties.[61] In light of these concerns, the ACCC notes that in the event of a breach of the Horticulture Code[62], the ACCC is currently limited to seeking the following remedies:

- declarations that particular conduct breaches the Act
- injunctions to stop the prohibited conduct continuing, or to require some action to be taken
- damages
- recision of relevant contracts
- community service orders
- corrective advertising.

However, the ACCC notes that in spite of the availability of these penalties, growers have indicated their reluctance to provide the ACCC with complaints against traders who have failed to comply with the Horticulture Code for fear of retribution.

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58 ibid., p. 9.

59 Grow SA, submission no. 112, p. 9.

60 ibid., p. 10.

61 SA Farmers Federation, submission no. 156, p. 3.

62 These remedies may be available if the Horticulture Code or consumer protection (e.g. misleading conduct) or unconscionable conduct provisions of the Act have been breached.

It is therefore the ACCC's view that the Horticulture Code may be more effectively enforced if the ACCC had the ability to conduct random audits of trader's and grower's records. This would enable the ACCC to investigate matters raised confidentially or anonymously by growers and in turn empower the ACCC to bring about compliance with the Horticulture Code.

Another aid to ensuring compliance would be the introduction of civil pecuniary penalties and infringement notices. Such enhancements would be consistent with those recently recommended by the Productivity Commission in its review of Australia's consumer policy framework inquiry report.[63] The ACCC considers that the ability to obtain civil pecuniary penalties, declarations and injunctive relief, and other measures such as corrective advertising within a single action would significantly enhance the ability of the ACCC to obtain effective outcomes. Infringement notice powers may also be appropriate in dealing with minor issues in a swift and less costly manner than taking court proceedings and may also have a deterrent effect.

Recommendation: that the Act be amended to introduce civil pecuniary penalties and infringement notices for a breach of a mandatory code made under Part IVB such as the Horticulture Code and that the ACCC be given powers to facilitate the conduct of random record audits as an enforcement mechanism under the code.

18.5.6 Extension of the Horticulture Code to cover retailers, exporters and processors

The current Horticulture Code does not regulate the sale of horticulture produce to retailers, processors or exporters as the final regulation impact statement prepared prior to the introduction of the Horticulture Code did not, on balance, indicate that these transactions required regulation under the code.

While the ACCC is aware that myriad arrangements exist within the horticulture industry whereby unprocessed horticulture produce is passed through the supply chain from grower to retailer, three key models have emerged.

Firstly, retailers may obtain supply of horticulture produce from wholesale traders that operate within the central markets. In these circumstances, retailers are unlikely to use written contracts as produce is generally purchased in this manner on an ad hoc basis in order to fill supply gaps. However, the ACCC notes that, unless the grower entered into an agreement with a trader prior to 15 December 2006, the first transaction in the supply chain between the grower and the wholesaler will already have been subject to the Horticulture Code. Therefore, there is little argument as to why the Horticulture Code should be extended to regulate transactions between the wholesaler and the retailer in these circumstances.

Secondly, retailers may seek direct supply of produce from growers who have been approved by the retailer as preferred suppliers. Retailers have increasingly sought to source horticulture produce directly from growers, rather than source the produce through the wholesale markets.[64]

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63 Productivity Commission 2008, *Review of Australia's consumer policy framework,* final report, Canberra.

64 Coles, submission no. 157, p. 16.

Coles, for example, submitted that:

> Securing the volume of fruit product required for the [full-service supermarket] has led the major retailers to negotiate direct supply arrangements with producers. This buying strategy, which mirrors changes in other developed markets, has provided security supply but has led to the balance of the crop being distributed by the capital city central markets.[65]

Coles further explained that:

> Direct supply improves competition and lowers costs by removing intermediaries and improving the scale opportunities, i.e. larger, more capital intensive efficient horticultural growers and stock producers delivering consistent quality and lower unit prices.[66]

In these circumstances, retailers provide approved suppliers with their standard terms and conditions of supply (usually in electronic form on the retailer's website[67]) and then place orders with those suppliers closer to harvest time. This gives the supplier the right to supply rather than guaranteeing that the supplier will receive an order.[68] These arrangements are generally not formalised into written contracts. In most cases retailers obtain supply directly from growers on an ongoing or ad hoc basis without the use of written supply agreements. Coles, for example, noted that its 'arrangements for the supply of fresh fruit from wholesale markets and growers are negotiated and agreed on a weekly basis.'[69]

While growers recognise that major retailers use their purchasing power to achieve the lowest purchase price[70], and to require strict adherence to detailed produce specifications and quality assurance procedures[71], retailers have been able to achieve a competitive advantage over wholesale traders by offering growers streamlined supply arrangements, prompt payment, stable revenue streams and access to a dispute resolution process through the voluntary PGICC.[72]

Growers and grower associations have raised concerns regarding the absence of written contracts when growers directly supply the major supermarket chains (MSCs), regarding the ambiguity inherent in applying the MSCs' produce specifications and regarding their ability to reject produce long after the produce has been delivered. For these reasons some growers and grower associations have supported the view that in order to ensure greater equity, transparency and certainty throughout the horticulture industry, the Horticulture Code should be extended to also cover first point of sale transactions between a grower and a retailer, processor or exporter.

The NSW Farmers Federation submitted, for example, that some growers in the apple industry found that they had little certainty when supplying directly to the MSCs. The federation explained that:

> In the apple industry supermarkets use verbal agreements and can gouge prices by placing an order at one price, two weeks ahead of delivery and offer a spot price upon delivery if the market has dropped.[73]

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65 Coles, submission no. 157, freshlogic report, p. 63.

66 ibid., p. 35.

67 Coles, submission no. 157, p. 16.

68 The Australian Chamber of Fruit and Vegetable Industries, Horticulture Code issues paper submission no. 14, p. 2.

69 Coles, submission no. 225, p. 13.

70 Coles, submission no. 157, freshlogic report p. 35.

71 Coles, submission no. 157, p. 16.

72 DAFF, *Horticulture Code of Conduct*, regulation impact statement, December 2006, p. 6. The PGICC is a voluntary set of guidelines promoting fair trading practices in the produce and grocery industry and provides a simple dispute resolution mechanism. The PGICC provides mediation service to all industry participants through the Produce and Grocery Industry Ombudsman mediation service. Unlike the Horticulture Code, the PGICC seeks to guide the conduct of all participants (except consumers) in the Australian produce and grocery industry, including: growers, processors, exporters, wholesalers, distributors and retailers.

73 NSW Farmers Association, submission no. 155, p. 19.

It further explained that:

> While growers' relationship with agents/merchants is the most problematic area, supermarkets are not guilt free. They offer no written contracts, only 'growing agreements', and produce specifications are not available for all produce lines leaving ambiguity and scope for dispute. Importantly, over 50 per cent of their produce is sourced direct from growers and is increasing. For these reasons, association supports retailer's inclusion within the code. The code must bring the whole horticulture supply chain under the one system [to include wholesalers, retailers, processors and exporters].[74]

The National Farmers Federation (NFF) also argued that:

> To reduce complexities with the administration of the code, the NFF believes that the code should apply to all parties involved in the first transaction from the grower to wholesalers, produce merchants, brokers, retailers, exporters and processors. In our view, the major retail chains and processors already offer contractual clarity and transparency in their dealings with horticulture growers. Therefore, including these parties within the code will not add any compliance costs or regulatory burden to these businesses.[75]

The National Association of Retail Grocers of Australia support the view that the 'inclusion of other retailers and major buyers into the code must strengthen the code'.[76] Similarly, Mr Bob Katter MP argued that the Horticulture Code should be extended to cover the retail supermarket chains to ensure there is transparency along the supply chain 'from paddock to plate'.[77]

The issue of rejection has also been raised as a major concern for growers who provide their horticulture produce directly to retailers. The ACCC notes, for example, that Coles' standard 'terms and conditions of supply' provide that Coles may reject produce back to the grower at the grower's expense at any time prior to 'acceptance' of the goods if the produce does not meet the specified standards. However, Coles is only deemed to have accepted goods under these standard terms 'once it has had a reasonable time after any latent defect has become apparent'.[78] Temperature-controlled produce can be rejected by Coles after a longer period, depending on the transport stage at which the problem is identified and up to a maximum of 48 hours from receipt at the distribution centre (subject to negotiations).'[79]

The ACCC also notes that Woolworths' 'standard national vendor trading terms' provide for an even longer opportunity to reject produce by stating that:

> If at any time, whether after delivery of or payment for the goods and not withstanding our acceptance of the goods, we find that the goods do not meet the standards and requirements set out in these terms we may notify you that we have rejected the goods, return the rejected goods to you at your own cost and require you to replace or repair the rejected goods immediately at your own cost. [80]

In spite of these apparent differences, evidence provided to the ACCC indicates that the practices of both MSCs in receiving, inspecting, accepting or rejecting produce is likely to be very similar. As a general rule, both MSCs seek to inspect produce on receipt and will at that time provide formal notice to the grower that the produce is to be rejected because of a failure to meet the required specifications.

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74 NSW Farmers Association, submission no. 155, p. 21.

75 National Farmers Federation, submission no. 137, p. 16.

76 The National Association of Retail Grocers of Australia, submission no. 129, p. 69.

77 Bob Katter, *Independent bid to rewrite Horticulture Code*, media release, 21 May 2007.

78 Coles, submission no. 225, p. 15.

79 ibid., p. 16.

80 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 95.

However, the ACCC is aware that in some instances the MSCs may reject some or all of a grower's produce at a subsequent time if a latent defect becomes apparent.

Some growers and grower associations have raised concerns regarding these practices by noting that a MSC may reject produce at the store level or the distribution centre or may seek to enter into a renegotiation with the grower regarding the price of the produce, depending on whether another party wants to supply that product to the retailer at a cheaper price. In contrast, it has also been noted that when retailers buy produce directly from the central market, they accept whatever price and quality is available at that time and there is little opportunity for subsequent rejection of produce.[81] Riverina Citrus noted that 'the rejection issue can come in at significantly different levels throughout the supply chain'[82], and explained that:

> The fruit then delivered from the packer through to the wholesaler has a rejection point in it. If it doesn't meet that wholesaler's requirements…it can either go direct to the wholesaler or to the retail chain distribution centre which also has the rejection process there, but even right through to store level it can get to the store and then be rejected at the store, either on delivery or post-delivery to come back.[83]

The ACCC has also heard evidence that growers can incur significant costs when produce is rejected by retailers, in terms of repackaging the produce and transporting that produce to another buyer where possible. The NSW Farmers Association noted that:

> … supermarkets have been known to reject specifically packaged produce. The farmer then has had to repackage the product at his expense, to be able to place his product on the open market, in [an] attempt to recover his losses.[84]

Some growers have also argued that while retailers provide growers with clear produce specifications, the interpretation of these specifications is often the source of some dispute.

Representative for Vernview Pty Ltd, Mr David Finger, acknowledged that:

> The specifications that [grocery] chains give us are very, very clear, and highly technical right down to temperatures and bricks and pressures, and you name it, it's in there, even to the length of the apple verses the width of the apple, versus all of these things. Most of my difficulties occur with rejections at [the] DC [distribution centre] about the interpretation of those specifications by my staff, by the QC [quality control] at the DC.[85]

The Chamber of Fruit and Vegetable Industries Western Australia also noted that if there is a dispute regarding the application of the produce specifications, the retailer is not required to attend mediation under the existing PGICC:

> The chamber understands that retailers that buy direct from growers already have clear terms of trade and usually purchase produce on a farm gate price basis. However there does not appear to be a mandatory dispute resolution process in place if these retailers trade contrary to the specifications detailed in their supply agreements. This leaves open the potential to manipulate produce orders, as specifications can be relaxed when produce supply is short, or alternatively specifications can be tightened during periods of oversupply.[86]

81 ACCC, public hearing transcript, Griffith, 8 April 2008, pp. 12–13.

82 ibid., p. 9.

83 ibid., p. 11.

84 NSW Farmers Association, submission no. 155, p. 19.

85 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 18.

86 The Chamber of Fruit and Vegetable Industries WA, Horticulture Code issues paper, submission no. 5, pp. 3–4.

Mr Finger further explained that when produce is rejected by the MSCs:

> They're very [formal]… they're forms that come by email. They even have photographs, all of that very detailed, almost as detailed as the specifications that you send it in under x amount of fruit. Major defect, minor defect, very detailed. The dispute arises over the interpretation of what's actually being seen and not being seen.[87]

It therefore appears that while retailers may provide their direct suppliers with clear specifications as well as prompt and formal notice regarding when and why produce has been rejected, growers may not be sufficiently clear about their rights and obligations as to when produce can be rejected and returned to them at their own cost under their agreement with the retailer.

The third model by which growers may provide produce to a retailer is through consolidators (also known throughout the industry as aggregators, intermediaries, service providers or retailer's agents).

Food and Agribusiness Consultant for Horticulture Australia Limited, Mr Shane Corniskey, explained that there is a huge diversity of relationships between growers and grower consolidators that vary from crop to crop.[88] This group includes growers who consolidate other growers' produce in order to supply a large retailer, and wholesalers who routinely sell growers'produce onto a retailer, while also selling produce at the central markets. While retailers may have ongoing arrangements with these consolidators[89], growers may have little indication as to whom their produce will be sold on or the role the consolidator will play in that transaction.

Despite the fact that these consolidators will often have obligations under the Horticulture Code to enter into a written horticulture produce agreement with a grower (as an agent or a merchant), evidence provided to the inquiry indicates that many fail to provide growers with a written supply agreement. The consolidator may provide the grower only with a retailer's publicly available produce specifications (although specifications are not always available for all lines) as a vague indication that the consolidator will on-sell the produce to that retailer.

The absence of written agreements in these transactions means that the capacity in which the consolidator acts in a transaction is often not made clear to the grower. The Victorian Farmers Federation explained that:

> On the whole, those of our members who deal directly with the two major chains don't have a lot of concerns, but those who deal with the major chains via the intermediary have a lot of concerns.[90]
>
> …
>
> One of the problems we have… is that there's not a clear differentiation between agents and brokers. And that when you go down the chain, the change of use, it gets very muddled on who is doing what. And that's one of the concerns.[91]

The Horticulture Australia Council also explained that:

> Growers frequently complain of tactics where wholesalers claim (either explicitly, or by requesting product to a certain retailers' quality and packaging specifications) to be acting on behalf of a particular retailer (i.e. as a buyer's agent). In some cases, of course, this is accurate. In many cases (to the detriment of the retailer's reputation), it is not.[92]

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87 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 19.

88 ACCC, public hearing transcript, Cairns, 4 April 2008, p. 15.

89 Coles, submission no. 225, pp. 13–14.

90 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 38.

91 ibid., p. 44.

92 Horticulture Australia Council, Horticulture Code issues paper, submission no. 26, p. 1.

It may, for example, appear to a grower from discussions with their consolidator that the consolidator is acting on behalf of the retailer in a particular transaction (i.e. as the retailer's agent), while the consolidator is actually purchasing the produce from the grower as a merchant, then selling the produce onto a retailer or to another wholesaler in the central markets. It may therefore be unclear to the grower whether any particular transaction entered into with a consolidator is regulated by the Horticulture Code. If the consolidator purchased the product as a true agent of a retailer, the transaction would not currently be regulated by the Horticulture Code. If, however, a trader is acting as a merchant by purchasing the produce outright from the grower in order to fill a retailer's order or to on-sell the produce onto the central markets, the transaction is currently regulated under the Horticulture Code and requires a written horticulture produce agreement.

While the arrangements between the parties will differ in each case, it is unlikely that consolidators do in fact operate as agents for retailers. Coles explained that 'The aggregators deal with the growers to source the fresh produce and on-sell it to Coles'.[93] Coles does not appear to engage these aggregators as their agents, in the strict legal sense, but rather seeks to purchase produce from these aggregators in their role as merchants who have already purchased the necessary produce from a range of growers.

It is therefore the ACCC's view that the MSCs do not currently engage consolidators as their legal agents. The Horticulture Code already regulates transactions between a grower and a consolidator in their capacity as either an agent or a merchant, but the transaction between a consolidator and a retailer is not currently regulated by the Horticulture Code.

The lack of transparency in these transactions is further highlighted when produce is rejected by a retailer or the consolidator. The Victorian Farmers Federation explained that when a retailer sources produce through a consolidator and the retailer rejects a grower's produce, the merchant may advise the farmer that their product does not reach the specifications required by the supermarket and the loss is then pushed back on the grower.[94] The Victorian Farmers Federation explained that the grower is often unclear as to where the rejected produce has been sent or how it has been dealt with following rejection. The Victorian Farmers Federation explained that '…when it's rejected by a supermarket, these agents then sell it off wherever they can'.[95]

Vernview Pty Ltd representative, Mr Finger, also commented that:

> The problem that arises is when you are actually supplying a supermarket chain through a potential black hole, because what happens in those situations is you pack to that very high specification and for whatever reason it's rejected from that third agent's system, not the more direct route. It's usually not shipped back to you to deal with, it's dealt with at that point, and so the traceability, the transparency of tracking that product, it's not there, and often, it's discounted far more than you would expect for the sort of problem that it would be rejected for at a DC [distribution centre] or at point of sale, retail.[96]

The Horticulture Australia Council noted that:

> … this tactic [of a merchant holding himself out to the grower as a retailer's agent] allows the supposed buyers' agent to reject product, based on the spurious assumption/assertion that it had been rejected by the retailer. This is frequently allied with an offer to "assist" the grower out of a difficult situation by placing/selling the product on their behalf; though ["naturally"] this will incur the penalty of a reduced return [that is, a price discount has been extracted from the grower]. In some

93 Coles, submission no. 225, p. 17.

94 ACCC, public hearing transcript, Melbourne, 12 May 2008, p. 46.

95 ibid., p. 38.

96 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 24.

cases, if the market is over-supplied, the produce will simply be returned at the growers' expense, of course, and in many cases, several days after [it] was received (and frequently with the quality impaired).[97]

The Horticulture Australia Council has therefore submitted that:

> … we are willing to consider (for reasons of equity, clarity and administrative simplicity) the possibility of one code (Horticulture Code of Conduct) which governs all transactions in the fresh produce sector. [98]

It has also been argued that exporters and processors should be regulated by the Horticulture Code as produce may originally be provided by a grower to a trader for export or processing, thereby avoiding regulation by the Horticulture Code and then subsequently be diverted back onto the domestic market for resale. The Western Australian Fruit Growers' Association Inc. argued that:

> Two issues for consideration are the structure of the supply chain, where export businesses deal through intermediaries who consolidate supply for another business, and the reassignment of export fruit for domestic purposes. In the latter, often for perfectly reasonable commercial factors, fruit initially consigned for export is sold on the domestic market, and these transactions by-pass the code.[99]

While the inquiry heard evidence that many growers are often satisfied with their direct supply arrangements with retailers, the ACCC's view is that growers may nonetheless be unclear regarding their rights and obligations. In particular, evidence provided to the inquiry indicates that growers are often unclear as to the manner in which retailers apply their product specifications and a retailer's' ability to reject produce at the grower's expense. The ACCC is also of the view that the inclusion of exporters and processors as 'traders' under the Horticulture Code can remove ambiguities that may arise when growers seek to determine whether the code applies in any particular instance.

Recommendation: that the Horticulture Code be extended to regulate first point of sale transactions of horticulture produce between a grower and a retailer, exporter or processor.

18.5.7 The Horticulture Code transitional arrangements

The exemption of pre-existing contracts (i.e. contracts entered prior to 15 December 2006) from regulation by the Horticulture Code raises a significant compliance and enforcement challenge for the ACCC because it is difficult to identify industry participants that currently fall within the scope of the Horticulture Code regulations.

Evidence provided to the ACCC indicates that a significant number of growers and traders opted not to move from written agreements existing before 15 December 2006 to agreements subject to the Horticulture Code, to avoid regulation by the Horticulture Code. The ACCC is aware that a significant number of growers entered into written agreements with traders just before 15 December 2006 to avoid coverage by the regulation.

The New South Wales Chamber of Fruit and Vegetable Industries explained that while the Horticulture Code was intended to cover the majority of the wholesale market:

> the code has not impacted significantly on the day-to-day business within the central market system. This is because most of the business is done between growers and wholesalers under pre-existing written agreements or between parties who are not subject to the code. [100]

97 Horticulture Australia Council, Horticulture Code issues paper, submission no. 26, p. 1.

98 Horticulture Australia Council, submission no. 63, p. 7.

99 Western Australian Fruit Growers' Association Incorporated, Horticulture Code issues paper submission no. 6, p. 3.

100 New South Wales Chamber of Fruit and Vegetable Industries, submission no. 99, p. 5.

The Australian Chamber of Fruit and Vegetables Industries (Australian Chamber) also commented that:

> The reality is that a lot of the business continues to be conducted on agreements entered into prior to the implementation of the code. Any growers and traders that have had a long term relationship have pre-existing agreements in place and those agreements are not subject to the code.[101]

The Australian Chamber explained that some traders are now reluctant to trade with growers who are not exempt from the Horticulture Code:

> One distinct result on behaviour in the marketplace is the reluctance of wholesalers to accept produce from new growers that wish to supply them. As most of the established growers and wholesalers are operating on pre-existing agreements a new supplier usually means increased paperwork, cost and a possibility of prosecution if a mistake is made in any of the requirements under the code. This means that the opportunity for grower to change to another wholesaler has been diminished. Unless the grower is substantial or able to provide a unique or vastly superior product, most wholesalers will not take the risk of operating with new growers under the code. Where existing growers have opted to trade under the code after its introduction, wholesalers are now assessing whether these growers are worth the extra time, cost and risk of prosecution in continuing to deal in their produce.[102]

The Australian Mango Industry Association explained that traders' reluctance to deal with growers who must comply with the Horticulture Code places growers in an untenable situation. Chairman of the Association, Mr Delis, recalled that:'

> I had on two occasions last year … people make contact with me personally asking for advice because they had been approached by their merchant asking them to sign a backdated agreement, and … they asked me what to do.[103]

Mr Delis further noted that:

> Unfortunately, growers are their own worst enemy despite the fact that they knew what was being asked of them and what the implications were and that they could actually make an issue of it, the comment was, "I still want to do business with these people".[104]

It is apparent from the evidence provided to the ACCC that as long as agreements entered into before 15 December 2006 are exempt from complying with the Horticulture Code, there will be reluctance by traders to enter into new code-compliant supply arrangements and there will be further confusion throughout the industry regarding when compliance is required.

The ACCC would therefore support the view put forward by the Mareeba District Fruit and Vegetable Growers Association that the Horticulture Code be amended to provide a sunset clause that would end the exemption currently provided to these pre-existing agreements.[105]

Recommendation: that the Horticulture Code be amended to regulate first point of sale transactions between a grower and a trader in horticulture produce, including transactions entered into under agreements made prior to 15 December 2006.

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101 Australian Chamber of Fruit and Vegetables Industries, submission no. 135, p. 8.

102 Australian Chamber of Fruit and Vegetables Industries, submission no. 135, p. 8.

103 ACCC, public hearing transcript, Darwin, 21 April 2008, p. 13.

104 ibid.

105 ACCC, public hearing transcript, Cairns, 4 April 2008, p. 81.

18.5.8 Delivery, ownership and the provision of services

The definition of 'delivery' and establishing price

It is the ACCC's view that the Horticulture Code requires a merchant to provide a grower with a set price (rather than a method or formula by which price may be calculated) before on-selling the produce to a third party.[106] Merchants are therefore prohibited from providing the grower with a formula or price range and then subsequently providing the grower with a share of the returns once the trader has secured their margin. In this way, the Horticulture Code aims to eliminate 'hybrid' transactions in which traders may minimise their risk in the produce while maximising their return by employing elements of both the merchant and the agent model.

Before the commencement of the Horticulture Code, a wholesaler would commonly establish the price the grower would receive for their produce, by first advising the grower of an indicative price before the produce was sent to market. After the produce was inspected, and in some cases on-sold, the wholesaler would remit to the grower the proceeds of the sale, less any commissions, fees or charges. While this hybrid system may provide flexibility for wholesalers to sell the produce onto another party at the 'market price', this pricing method leaves the grower uncertain as to the amount they can expect to receive for their produce.

This system also means that produce rejected by the third-party purchaser may be returned by the trader to the grower for any reason whatsoever (e.g. oversupply of the produce), in spite of the fact that the trader holds themselves out as a 'merchant' throughout the transaction. Again, the trader is able to avoid taking any risk in the produce they 'purchased' by passing the loss back onto the grower. For these reasons, the government decided that, on balance, the Horticulture Code would achieve greater clarity and transparency by requiring traders to act as either agents (who must provide reports to growers and allow the grower to inspect the agent's relevant records) or merchants (where price is agreed in writing before produce is despatched or immediately upon delivery of the produce to the merchant).

However, it has been argued by wholesalers and the central market chambers that the definition of 'delivery' in the Horticulture Code in conjunction with the requirement to agree on an actual price, as opposed to a formula or indicative price, before or immediately upon delivery, creates considerable additional paperwork and imposes the impractical requirement of inspecting large volumes of produce and then contacting growers in the very early hours of the morning to negotiate price. Brisbane Markets Limited explained that:

> It must also be understood that wholesalers cannot physically negotiate prices in the time between the receipt of produce and the opening of trade. Receipt of product generally begins at 2 am and trade commences at 6 am. The sheer volume of transactions makes making agreements in writing impossible. If wholesalers attempted to agree prices on delivery for all produce entering the markets, the system would collapse. That is why the state-based farm produce marketing legislation allowed for price setting on merchant transactions after the produce received had been made available for sale. It is also why many wholesalers and growers entered into pre-code contracts.[107]

Furthermore, some wholesalers and the central market chambers argue that the requirement to establish a price before knowing the true value of that produce in the market on that day will result

106 Clause 25 of the Horticulture Code.

107 Brismark, submission no. 68, appendix 1: Brismark submission to the Horticulture Code Committee, p. 4.

in substantially lower prices being paid to growers as merchants seek to manage their risk. The Horticulture Code Committee explained that:

> … traders argue that this requirement is unworkable, as they [the merchants] do not have enough resources to price all the produce early in the morning when produce is delivered and sold and at the same time to obtain a grower's written agreement to the proposed price.[108]

The Horticulture Code Committee suggested that 'much of the resistance to the code could be overcome if a more flexible method of agreeing price in merchant transactions was introduced into the code'.[109] The Horticulture Code Committee also suggested that:

> … it may be appropriate to allow a method, based on the merchant sale price, to be used to calculate price in a merchant transaction with appropriate and additional reporting requirements. This may provide growers with appropriate levels of transparency and provide wholesalers, inside and out of the central markets, with the flexibility to obtain returns for growers.[110]

The ACCC agrees that these practical difficulties may be alleviated by requiring the merchant to provide the grower, before delivery, with either a price or a method for calculating a price. The ACCC also recommends that if the merchant does not reject the produce within 24 hours of physical delivery, the produce is deemed to be accepted. Ownership of the produce transfers when the produce is accepted by the merchant. The ACCC notes that, as set out in clause 14 of the current Horticulture Code, the merchant must exercise all reasonable due care and skill in handling and storage of the grower's produce to ensure that the produce remains of the highest quality possible while the grower's produce is under the control of the merchant (i.e. following delivery but prior to acceptance of the produce). The ACCC also recommends that a range of other mechanisms set out below be put in place to ensure that both parties are provided with adequate clarity and transparency when they enter into these transactions.

The definition of 'delivery' and the provision of services

As the Horticulture Code is currently drafted, the term 'delivery' can have two meanings when produce requires ripening or other services. Delivery can refer to the time when produce arrives for conditioning or storage, or it can refer to the time when produce is ready for sale. As the Horticulture Code does not permit a merchant to charge a grower a fee for services performed under a horticulture produce agreement, merchants have sought to enter into service agreements in order to provide growers with other services such as warehousing; ripening and conditioning; sorting; packing; grading; cold storage; and food safety services. The Horticulture Code does not apply to these service agreements.

Where a grower and a merchant enter into a separate service agreement:

- the grower retains ownership of the produce for the duration of the service agreement
- the produce may subsequently be either physically delivered or deemed to be delivered to the merchant under the parties' horticulture produce agreement when the service agreement for that consignment ends.

If the merchant already has custody of the consigned produce, delivery will be deemed to have taken place when the horticulture produce agreement begins.

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108 Horticulture Code Committee, submission no. 32, pp. 5–6.

109 ibid., p. 6.

110 Horticulture Code Committee, Horticulture Code issues paper submission no. 24, p. 2.

However, it is the ACCC's view that these arrangements are both unnecessarily complex and artificial. The recommendation outlined above therefore seeks to enable the merchant to purchase produce from the grower and deduct the cost of any services that are required to prepare the produce for resale, as part of the price or as part of the method for calculating a price.

Recommendation: that the Horticulture Code be amended as follows:

- The price paid by a merchant for the purchase of a grower's produce may be an amount or a method for calculating an amount.
- The price or a method for calculating the price must be agreed in writing between the merchant and the grower before delivery of the produce to the merchant.
- Any agreed method used to calculate a price must be by reference to the amount received by the merchant from the sale of the produce to a third-party purchaser.
- If the merchant does not reject the produce within 24 hours of physical delivery, the produce is deemed to be accepted. Ownership of the produce transfers when the produce is accepted by the merchant. (As set out in clause 14 of the current Horticulture Code, the merchant must exercise all reasonable due care and skill in handling and storage of the grower's produce to ensure that the produce remains of the highest quality possible while the grower's produce is under the control of the merchant).
- The merchant must seek consent from the grower regarding any non–arms-length transactions.
- If the parties use an agreed method to calculate a price, the merchant must report to the grower regarding how the price was calculated according to the agreed method.
- If the parties use an agreed method to calculate a price, the merchant must permit the grower, or an appropriate representative, to inspect records that relate to the grower's produce.
- The merchant is liable for any bad debts arising from the sale of the produce to a third-party and any produce returned by a third-party purchaser.
- The merchant may provide the grower with services as part of a horticulture produce agreement and deduct the cost of any services that are required to prepare the produce for resale, as part of the price or as part of the method for calculating the price.

18.5.9 Rights and obligations of agents under the Horticulture Code

The Horticulture Code requires that a grower and an agent must enter into a horticulture produce agreement that sets out how transactions between them are to take place.[111] The Horticulture Code defines an 'agent' as a person who sells horticulture produce on behalf of a grower to a third-party purchaser for a commission or fee[112], and provides that an agent must act in the best interests of the grower and sell the grower's produce on an arm's-length basis.[113]

An agent is also required to report to the grower regarding the details of the transaction[114] and to enable the grower, or their representative to inspect the relevant agent's records.[115] However, agents are not required to give the grower the name and contact details of the buyer unless it is explicitly stated in the horticulture produce agreement that it is the responsibility of the grower to recover bad

111 Clauses 6 and 9(3) of the Horticulture Code.
112 Clause 3 of the Horticulture Code.
113 Clause 18 of the Horticulture Code.
114 Clause 20 of the Horticulture Code.
115 Clause 22 of the Horticulture Code.

debts and that information is required in order to do so.[116] Since the Horticulture Code requires a clear distinction between those traders who act as agents and those who act as merchants, it has become apparent that, with the exception of the Perth and Adelaide central markets, very few traders at the central markets act as agents for the following reasons.

Goods and services tax

An agent transaction attracts goods and services tax (GST) on the service the agent provides to the grower in marketing their produce. While agents may already be registered with the Australian Tax Office for the purpose of GST collection, the obligation to declare the full extent of the services that they provide to growers may deter some traders from acting as agents. Some traders therefore seek to continue to trade as 'merchants' while utilising the benefits of the hybrid system of trade.

Bad debt

The Horticulture Code provides that a bad debt that arises from the sale of the grower's produce by their agent to a third party is the grower's bad debt (rather than the agent's bad debt).[117] If the grower's agent is to pursue the bad debt, the parties must set out in their horticulture produce agreement the scope of the agent's authority in this regard. For example, the agent may be authorised to utilise a credit marketing service or a subagent such as a debt collection agency, to pursue the debt on behalf of the grower.

Where the parties' horticulture produce agreement provides that the grower will pursue their own bad debts, the Horticulture Code specifies that the agent must provide the grower with the name and contact details of the third-party purchaser, in order that the grower can pursue that debt.[118] However, agents are often very reluctant to provide growers with these details for fear that growers may take the opportunity to circumvent the agent and deal with the third-party directly in the future. Growers are often not well placed to effectively collect debts from third-party purchasers. For example, most market credit services, which operate within the central markets to assist their trader members to collect their debts, do not collect debts on behalf of growers. On the other hand, the use of horticulture produce agreements that assign the recovery of a grower's bad debts to an agent, may act as a disincentive for a trader to act as an agent as they may perceive that there will be more work to complete before they receive their commission or fee.

In order to resolve these concerns, it may be more appropriate for the Horticulture Code to only permit an agent to recover their fee or commission for services performed under the agency agreement as a deduction from amounts paid by the third-party purchaser. This creates an incentive for the agent to recover the outstanding debts while compensating the grower if they must pursue the debt directly. Accordingly, if it is agreed that a grower shall pursue the debt themselves, the agent will not recover their commission relating to that sale.

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116 Clause 23 of the Horticulture Code.

117 Clauses 19 and 23 of the Horticulture Code.

118 Clause 23 of the Horticulture Code.

Reporting to growers

It has also been argued by the central market chambers that the reporting obligations set out in the Horticulture Code[119] act as a significant deterrent to traders that may otherwise act as agents. In particular, Brisbane Markets Limited argued that:

> Wholesalers who source multiple grades and sizes of products from many different growers and combine those lots to fill complex orders cannot meet agency reporting requirements in a cost effective manner. This is a major reason why some wholesalers are not prepared to consider trading with growers on an agency basis. [120]

However, the ACCC is aware that the industry increasingly requires all parties to maintain comprehensive quality assurance records to enable any produce to be effectively traced through the supply chain back to the farm gate. It therefore appears that the obligations placed on agents under the Horticulture Code complement this broader shift towards greater transparency throughout the supply chain.

Inspection of an agent's records

While the Horticulture Code permits a grower's representative to inspect an agent's records regarding the sale of their produce[121], the code does not stipulate who the grower's representative can or cannot be. While it may be unlikely, this could enable a grower to appoint an agent's competitor to inspect the agent's records on the grower's behalf. It would therefore be appropriate to amend the Horticulture Code to enable an agent to prevent a person who may be the agent's competitor, from being appointed to inspect the agent's records on the grower's behalf.

Recommendation: that the Horticulture Code be amended to:

- only permit an agent to recover their fee or commission for services performed under the agency agreement as a deduction from amounts paid by the third party purchaser. Accordingly, if it is agreed that a grower shall pursue the debt themselves, the agent will not recover their commission relating to that sale.
- enable an agent to prevent a person who may be the agent's competitor, from being appointed to inspect the agent's records on the grower's behalf.

18.5.10 Packing houses and cooperatives

Growers from several large sectors of the horticulture industry, including the citrus, apple, pear and avocado sectors, provide their produce to cooperatives/packing houses before it is on-sold. However, the Horticulture Code does not contain any specific reference to packing houses or cooperatives. The application of the Horticulture Code to transactions involving these entities is therefore determined on a case by case basis. A transaction between a cooperative/packing house and a grower is currently regulated by the Horticulture Code if the cooperative/packing house acts as either a merchant (purchasing and then on-selling the grower's horticulture produce) or an agent (selling the grower's horticulture produce on behalf of the grower).

If the owner of a cooperative/packing house grows their own horticulture produce for sale, they will be defined as a grower for the purposes of the Horticulture Code. However, when several growers

119 Clause 20 of the Horticulture Code.

120 Brismark, submission no. 68, appendix 1: Brismark submission to the Horticulture Code Committee, p. 4.

121 Clause 22 of the Horticulture Code.

deal with a cooperative/packing house, the Horticulture Code may apply to a transaction between the growers and the cooperative/packing house if the cooperative/packing house:

- is a separate legal entity from the growers (this legal entity may be owned collectively by the growers or by an individual grower) and acts as an agent, selling horticulture produce on behalf of the grower for a commission or a fee, or
- acts as a merchant, buying the grower's horticulture produce to on sell it.

However, it is the ACCC's view that the Horticulture Code does not apply to subsequent transactions in which the cooperative/packing house on-sells the produce to another trader because these will not be transactions between a grower and a trader. Instead, they are transactions between two traders.

This interpretation of the Horticulture Code ensures that all cooperatives/packing houses that act as agents or merchants, whether they are grower-owned or not[122], are transparent in their dealings with growers. However, it should be noted that where the first transaction is between a grower and a cooperative/packing house, traders in the central markets are not required to enter into a horticulture produce agreement.

Some growers and grower associations have raised concerns that where the first transaction is between a grower and a cooperative/packing house, traders in the central markets will not be required to enter into transparent horticulture produce agreements as they will not be regulated by the Horticulture Code. For instance, the Horticulture Code Committee noted that:

> Growers & grower-owned cooperatives believe that the first point of transaction that should be covered by the code is the one between the grower-owned cooperative and the trader, as this is where the actual sale of produce takes place.[123]

The NSW Farmers Association explained that in its view:

> The Horticulture Code currently sweeps pack houses, cooperatives and other marketing organisations up within the definition of a 'trader' which then excludes the relationship between the cooperative and the trader from regulation.[124]

The association suggested that:

> Amending the Code regulation to include all cooperative like or produce pooling structures, which are registered with the Australian Taxation Office, under the definition of a "grower" will focus the transparency back on the relationships which exercise market power against the growers' interests.[125]

In support of this argument, Mr Plunkett, Deputy Chair of the Fruit Growers of Victoria, commented that he sees little value in the Horticulture Code regulating the arrangements between growers and their co-operatives or packing houses. He explained that:'

> … in my case…we pack our own fruit, and we also pack fruit for about twenty other growers. Under the current definition of the code, the code applies from the first transaction from the farmer, so the code is applying between myself and the grower next-door'.[126]

122 However, if a grower owns a cooperative/packing house and the cooperative/packing house is the same legal entity as the grower, the Horticulture Code will not apply where the grower passes their own produce onto the cooperative/packing house. The code then applies to subsequent transactions of the grower's produce between the cooperative/packing house (which is the same legal entity as the grower) and a trader (as defined in the code).

123 Horticulture Code Committee, submission no. 32, p. 4.

124 The NSW Farmers Association, submission no. 155, p. 22.

125 ibid.

126 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 57.

The North Queensland Banana Growers Cooperative also argued that although the government has spent significant amounts of money encouraging growers to form cooperatives in order to market more effectively, the application of the Horticulture Code to transactions between growers and grower-owned packing houses and cooperatives was a disincentive for growers to form such cooperatives.[127]

In response to these arguments, Brismark (the Queensland Chamber of Fruit and Vegetable Industries Co-operative) submitted that such:

> exemptions are unfair, placing burdens on only one part of the industry, giving other parts a competitive advantage and distorting the market. As the Central Market wholesalers have borne the greatest cost in relation to the Code we oppose any further exemptions or charges that will shift even more of the impacts of the Code onto our members.[128]

Brismark argued that:

> Many grower packhouses are not cooperatively owned, and many have a very strong position in terms of their negotiating power with their grower suppliers. Clearly, a portion of the complaints and misunderstandings that occur within the industry relate to the grey area which can exist when one grower is marketing both their own and other grower's produce.[129]

It added that:

> It should also be noted that packing houses, whether grower owned co-operatives or not, are separate legal entities and have not always acted in the best interests of their suppliers.[130]

The Chamber of Fruit and Vegetable Industries in Western Australia (Inc.) also supported the view that:

> Trading entities involving grower ownership are no different to businesses without grower ownership they are both in the business of buying and selling fresh produce from growers to another party. On a national scale there are some very large scale businesses with grower shareholdings ... many of these operations have trading floors in central markets and it would be discriminatory to apply the code to some trading floors in central markets and not others.[131]

The ACCC recognises that the 'cooperative/packing house' category is a broad one that incorporates a range of entities, some of which are wholly and equitably owned by a small number of growers while others are large, remote entities dominated by a small number of growers with little interest in operating in a way that is clear and transparent to its smaller members. The ACCC is also aware that exempting these parties from the Horticulture Code may enable some traders to seek to avoid their obligations under the code by assuming the identity of a cooperative/packing house[132], which may in turn disadvantage growers and bring about further compliance and enforcement challenges.

In light of these arguments, it is the ACCC's view that transactions between a grower and a cooperative/packing house in which the grower has a significant interest should be exempt from regulation under the Horticulture Code. However, the manner in which such a cooperative/packing house is dealt with under the Horticulture Code should vary depending on whether the cooperative/packing house purchases the produce outright from the grower or merely markets the grower's produce onto a third party.

Recommendation: that the Horticulture Code be amended to ensure that transactions between a grower and a cooperative/packing house, in which that grower has a significant interest, are exempt

127 ACCC, public hearing transcript, Cairns, 4 April 2008, p. 89.

128 Brismark, Horticulture Code issues paper, submission no. 9, p. 10.

129 Brismark, Horticulture Code issues paper, submission no. 10, p. 13.

130 Brismark, Horticulture Code issues paper, submission no. 28, p. 4.

131 The Chamber of Fruit and Vegetable Industries in Western Australia (Inc.), Horticulture Code issues paper, submission no. 5, p. 5.

132 Centre for International Economics, *Horticulture Code of Conduct,* draft regulation impact statement, July 2005, p. xix.

from regulation under the Horticulture Code where the cooperative/packing house 'markets' the grower's produce.

The ACCC also recommends that transactions in which a grower sells their produce to a cooperative/packing house should be exempt from regulation under the Horticulture Code where the grower has a significant interest in that cooperative/packing house.

The precise mechanism by which this result is achieved should be considered by the Horticulture Code Committee in consultation with the industry.

18.5.11 Pooling of produce and price averaging

The Horticulture Code requires that an agent must pay the grower the money received for that grower's produce after subtracting any commission or agent fees permitted under the horticulture produce agreement and any extra amounts that may be deducted under the agreement. The ACCC's view is that the practice of paying growers a price based on the average price received by the agent for a pool of produce (i.e. where various grades of produce from various growers are mixed together and then sent by the agent to be sold in markets throughout Australia) is not permitted under the Horticulture Code.

However, the ACCC's view is that the Horticulture Code permits agents to pool produce received from a different grower, if the agent also complies with the following obligations:

- The agent must act in the grower's best interests when selling their produce under a horticulture produce agreement.
- The agent must be able to trace and record where, to whom and for how much each grower's produce was sold.
- The agent must meet all their reporting obligations set out in the code.
- The agent must let the grower or their representative inspect those parts of the agent's records pertaining to the grower's produce.
- The grower has a role under the horticulture produce agreement in the collection of bad debts; the agent must provide the grower with the names of the purchasers.

The ACCC has heard evidence that the broader practice of pooling different growers' produce and averaging the price received in different markets across produce gradesarguably distorts the market by obscuring the true market indicators[133], removing the ability to trace crop disease and providing growers with little incentive to improve productivity or the quality of their produce, as growers that produce high-quality produce can only expect an average price under this system.[134]

However, the ACCC has also heard evidence from a sector of the horticulture industry that supports these practices as a mechanism that enables growers to continue to manage their risk in circumstances where there are significant fluctuations in produce prices over time and across various markets throughout Australia.

Horticulture Australia Limited explained that:

> an anomaly exists, however, in the [Horticulture Code] whereby network growers through the provision of service providers such as an agent, merchant or non-grower consolidator, have their returns "averaged" through a pooling mechanism. Under the current definitions of the [code], an

133 Chairman of the Australian Mango Industry Association, Mr Peter Delis, ACCC, public hearing transcript, Darwin, 21 April 2008, p. 11.

134 President of Mareeba District Fruit and Vegetable Growers Association, Mr Joe Moro, ACCC, public hearing transcript, Cairns, 4 April 2008, pp. 79–80.

agent, merchant or non-grower consolidator would be committing an offence under the [code], despite the fact that the network growers are in agreement that it should occur.

…For example, a group of growers may decide to have their returns averaged by the agent, merchant or non-grower consolidator on the basis of a period of time (week, month or year), regional location, across a grade/s, end user/customer, etc. The group of growers may willingly enter into such an arrangement so that inequities or perception of same do not occur. By pooling, a marketer does not have to be concerned which growers product goes to which market. For instance, if an export market is being developed which provides lower returns initially, the marketer does not need to be concerned that all of grower A's product continues to go to export, because with pooling they will receive some of the benefit of going to the higher priced markets through averaging.

…Pooling does not imply that packout is not a major factor in net return calculations or that the transaction is not transparent.

…

Network growers or other similar grower groups have expressed concerned that the [code] does not cover this eventuality which is quite common across a broad range of fruit and vegetables.[135]

The Fruit Growers of Victoria Limited explained that the price of some produce has a long selling season and varies significantly over that season. It may even drop below the cost of production for a period. Smaller growers have benefited from the ability to pool and average the price—enabling produce to be held in cool storage and slowly released onto the market over time. This system enables growers to share freight costs and work together to meet large orders.[136]

Vernview Pty Ltd representative, Mr Finger, also commented that these practices may limit price fluctuations that would otherwise be passed onto the consumer.[137] The Geoffrey Thompson Fruit Packing Company Pty Ltd noted that as these practices are not permitted under the Horticulture Code:

there could be a substantial variation in the price paid to any particular grower, due to the timing of packing their fruit, which is largely out of the control of the grower. This can result in a price on the day that is significantly below the growers cost of production if the growers fruit is packed when the selling price is distressed…the smaller the grower, the larger the likely price fluctuations due to their entire crop being packed on one particular day.[138]

On balance, it is the ACCC's view that the Horticulture Code should be amended to enable the horticulture industry to continue to manage its risks through the practice of pooling and price averaging. However, the ACCC would encourage the industry to adopt practices that encourage pooling and price averaging of similar quality produce, to ensure growers receive accurate price information regarding the market value of their produce.

Recommendation: that the Horticulture Code be amended to permit agents and growers to engage in pooling and price averaging of produce.

18.5.12 Grower sheds

Three of Australia's central fruit and vegetable markets (the Sydney, Adelaide and Melbourne central markets) incorporate an area which is commonly called a 'grower shed'. A grower shed is that part of a central fruit and vegetable market reserved for growers to sell their produce directly to a diverse group of purchasers, including wholesalers, processors, exporters, provedores, retailers, consumers and

135 Horticulture Australia Limited, submission no. 167, p. 51.

136 ACCC, public hearing transcript, Shepparton, 14 April 2008, p. 60.

137 ibid., p. 26.

138 Geoffrey Thompson Fruit Packing Company Pty Ltd, Horticulture Code issues paper, submission no. 2, p. 1.

other growers. Growers may use a grower shed to sell their own produce directly to purchasers and/or to sell other grower's' produce on an agent or merchant basis. Transactions undertaken by growers who trade in a grower shed typically involve a high frequency of small quantity (and therefore low value), face-to-face, short-term 'spot' sales. For example, approximately 480 growers are currently registered as permanent or casual users of the grower shed within the Sydney central market and approximately 300 growers trade in this grower shed on any one day.

The following types of transactions that take place within a grower shed are currently regulated by the Horticulture Code:

- a grower who sells their own produce to a merchant
- a grower who sells their own produce through an agent
- a grower who sells their own produce to another grower, who acts as a merchant
- a grower who sells their own produce through another grower, who acts as an agent.

The Horticulture Code provides that the first purpose of the code is 'to regulate trade in horticulture produce between growers and traders to ensure transparency and clarity of transactions'.[139] In order to establish transparency and clarity throughout these transactions, the Horticulture Code requires that the agreement states whether the trader is trading as an agent or merchant under the agreement.[140]

However, a grower operating out of a grower shed may not have the opportunity to establish whether a purchaser is purchasing the produce in the capacity of a merchant, agent, retailer, exporter, processor, consumer or as another grower. Similarly, the purchaser may be unclear whether the grower is selling their own produce or selling produce on behalf of another grower. If the capacity of the parties entering into the transaction is unclear, it will also be unclear whether the transaction is regulated by the Horticulture Code and therefore whether the parties involved need to enter into a written agreement that complies with the code. For these reasons it may be difficult for parties trading in a grower shed to comply with the Horticulture Code and for the ACCC to effectively bring about compliance with the code.

In spite of the lack of clarity regarding the capacity of the parties to these transactions, it is arguable that transactions entered into in a grower shed are, on the whole, more transparent and clear than long-term, long-distance agreements. This is because a purchaser of produce from a grower shed is typically able to inspect the produce, negotiate a price for the produce and collect the produce in person within a very short period of time. It is also foreseeable that growers that operate out of a grower shed are less likely to be able to absorb the regulatory compliance costs involved in complying with the Horticulture Code than those growers that are engaging in high-volume, high-value transactions.

For these reasons, it may be more appropriate for parties that enter into agreements in a grower shed to be exempt from the Horticulture Code while retaining the ability to access the Horticulture Code's dispute resolution procedure established under parts 5 and 6 of the code. The code will also need to clearly define the nature of the trade that may take place within a grower shed to ensure that other traders are not able to shift their operations into a grower shed to avoid compliance with the code.

Recommendation: that the Horticulture Code be amended to exempt transactions that are entered into in a grower shed from regulation under the code. However, it is recommended that parties

139 Clause 2 of the Horticulture Code.

140 Clause 9(2)(a) of the Horticulture Code.

that enter into these transactions be permitted to access the Horticulture Code's dispute resolution procedure established under parts 5 and 6 of the code.

18.5.13 Dispute resolution procedures

Disputes regarding transactions between growers and wholesale traders of unprocessed horticulture produce[141] may currently be resolved according to two distinct dispute resolution mechanisms: the dispute resolution procedure established under the Horticulture Code or the dispute resolution procedure established under the voluntary PGICC. However, disputes regarding transactions that involve other groups within the broader produce and grocery horticulture supply chain (such as retailers, processors and exporters) are limited to the dispute resolution scheme established under the PGICC.

The main objective of the Horticulture Code's dispute resolution procedure is to provide growers and wholesale traders, who have agreements under the code, with a fair and equitable dispute resolution mechanism. The Horticulture Code provides that growers and traders may use any dispute resolution procedures they choose to resolve horticulture disputes that arise between them. However, if either a grower or trader wishes to use the Horticulture Code's dispute resolution procedure, the other trading party must comply.[142]

In contrast, the PGICC is a voluntary code that applies to a broad range of industry participants including:

> those businesses involved in the production, preparation and sale of food, beverages and non-food grocery items, including (but not limited to) primary producers, manufacturers and/or processors, wholesalers, importers and/or distributors, brokers and/or agents and grocery retailers.[143]

Moreover, the PGICC does not exempt agreements entered into before 14 May 2007 as is the case with the Horticulture Code. However, the ACCC notes that while the PGICC enables retailers to access the dispute resolution scheme, the PGICC has acknowledged that under the voluntary code dispute resolution process 'there has been minimal dispute activity in relation to the retailers'.[144]

An additional difference between the Horticulture Code and the voluntary code is that the former provides for the appointment of the horticulture mediation adviser who can assist parties to resolve their disputes and, on request, appoint mediators from a specialist panel of experienced mediators across Australia. The horticulture mediation adviser has established a list of horticulture produce assessors who can investigate and report on any matter arising under a horticulture produce agreement. The Horticulture Code also enables parties to a horticulture produce agreement to use the services of an assessor to investigate a matter and report the findings in relation to the issues in question.

The ACCC notes that the availability of assessors under the Horticulture Code may assist parties to resolve a dispute without the need for a formal mediation, and that in a case where a dispute proceeds to mediation, the use of assessors is likely to result in a more efficient and fair outcome. However, it appears that these assessors have rarely been called upon since the commencement of the Horticulture Code. The reason for this may be the lack of awareness regarding their role under the

141 Clause 3 of the Horticulture Code.

142 Clause 30 of the Horticulture Code.

143 Clause 4 of the Produce and Industry Code of Conduct. However, it is important to note that while the PGICC dispute resolution procedure is voluntary and no party is bound to participate, if a party were to hold itself out as endorsing the PGICC, but refused to participate in the dispute resolution process established under that code, this might raise some concerns for the ACCC because it might potentially constitute misleading or deceptive conduct under s. 52 of the Act.

144 ACCC, public hearing transcript, Melbourne, 30 May 2008, p. 4.

Horticulture Code. According to the Horticulture Code committee, 'there is lack of knowledge of the code, the horticulture mediation advisor and horticulture produce assessors.'[145]

The ACCC also notes that the use of horticulture produce assessors can only be effective if such a service is available to industry participants in a timely manner (because the dispute is in relation to the quality of fresh produce). The need for urgency when assessing fresh horticulture produce may also explain why industry participants have not more widely utilised the services of these assessors to date.

The Australian Government subsidises the full cost of the mediator's fees under both schemes, with the exception of an application fee of $50, which is payable by the parties to enable them to undertake mediation.[146]

However, unlike the PGIO mediation service, the Horticulture Code provides that the parties will generally be required to share the costs for any video conference, telephone conference, venue or travel costs incurred by the mediator.

Both dispute resolution procedures encourage the parties to resolve their disputes prior to mediation.[147] Under the Horticulture Code, the two parties are at first encouraged to attempt to resolve the dispute themselves and, if that fails, may participate in mediation as described above. However, statistical data from the PGICC indicates that the number of the dispute resolution inquiries and mediations undertaken by the PGIO has been decreasing since July 2001. The PGICC noted, for example, that of the 587 registered dispute inquiries received by the PGIO since 2001, 240 proceeded to apply for mediation, of which 170 proceeded to mediation and 151 ended in a contractual resolution of the dispute.[148]

According to the new PGIO mediation service established in 2006, in which the PGIO administers a panel of mediators and no longer has a promotional role[149], the PGIO now focuses on seeking to resolve disputes before escalating disputes to mediation. These changes to the PGIO mediation service appear to have resulted in a further reduction in the number of dispute inquiries and the number of disputes escalated to mediation. The PGICC noted, for example, that during 2006–07 and 2007–08, the number of dispute inquiries fell to a total of only 70, of which only 12 became mediation applications, seven proceeded to mediation and six entered signed agreements. However, it is unclear whether these trends are due to early resolution of disputes by the PGIO prior to mediation, reduced awareness of the service, increased use of internal dispute resolution procedures or otherwise.[150]

Regardless of which dispute resolution mechanism a party may use, it is apparent that most parties prefer to settle their disputes within an internal dispute resolution process rather than utilising a mediation service. This may suggest that both parties seek to resolve their disputes as quickly as possible. Alternatively, it may also suggest that larger industry participants are reluctant to use external dispute resolution procedures due to the affect it may have on their reputation and that smaller party's fear retaliation or victimisation if they insist on pursuing matters through a formal mediation process.

On balance, the ACCC considers that the dispute resolution procedure established under the Horticulture Code may offer complainants greater certainty that the matter will be resolved, as the other

145 Horticulture Code Committee, submission no. 32, p. 3.

146 See www.hortcodema.com.au and www.produceandgrocerycode.com.au.

147 The Produce and Grocery Industry Code Administration committee, submission no. 50, p. 3.

148 ibid., pp. 5–6.

149 The same provider undertakes mediation services for the PGICC and the Horticulture Code. However, mediation under the Horticulture Code is compulsory should either party request it, whereas mediation remains voluntary under the PGICC.

150 The Produce and Grocery Industry Code Administration committee, submission no. 50, p. 3.

party is bound to participate in the dispute resolution procedure[151], whereas, under the PGICC, both parties need to agree to participate in such a process. The voluntary nature of the PGICC enhances the ability of a party with more market power to pressure a party with less market power to settle a dispute outside of these formal dispute resolution mechanisms, as both parties must agree to participate before the process can proceed. In contrast, the Horticulture Code enables a party with less market power to require a party with more market power to participate in the code's formal dispute resolution procedure.

The dispute resolution procedure established under the Horticulture Code therefore appears to offer a party with less market power an opportunity that may not otherwise be available to participate in an independent dispute resolution process rather than a less formal, voluntary process that may effectively be managed by the other party.

Recommendations: that the costs incurred by the parties to a dispute under the Horticulture Code dispute resolution procedure be subsidised by the Australian Government to the same extent as the voluntary PGICC, and that the ACCC undertakes to provide further education relating to the Horticulture Code and its dispute resolution procedures, including about the role of assessors in resolving disputes.

151 Clause 30 (2) of the Horticulture Code.

19 The role of the Trade Practices Act in addressing impediments to competition

Key points

- Recent growth by the major supermarket chains (MSCs) has largely occurred through organic growth rather than growth through acquisitions. While creeping acquisitions are not currently an issue in the grocery industry, they are a broad issue that can affect many industries. The ACCC accordingly maintains its support for the introduction of legislation that would better allow it to address creeping acquisitions more generally.
- A number of parties raised allegations of predatory pricing by the MSCs. While specific examples were provided of vigorous price discounting by the MSCs which competitors struggled to match, such conduct does not of itself constitute predatory pricing. Price competition of this nature is often pro-competitive and can deliver benefits to consumers. The ACCC was not presented during the inquiry with examples of conduct that would appear to constitute predatory pricing. It does not consider that specific predatory pricing rules need to be introduced for grocery retailing. However, it recognises that predatory pricing is a potential concern in the grocery industry.
- A number of parties raised concerns about price discrimination. Price discrimination often has sound efficiency justifications and can deliver benefits to consumers. The ACCC considers that the existing provisions of the Act are sufficient to address instances where price discrimination is used in an anti-competitive manner.

19.1 Introduction

This chapter focuses on Part IV of the *Trade Practices Act 1974* (the Act) and possible measures that have been raised during the inquiry to deal with concerns about the retail grocery industry. Chapter 1 examined much of the work that has been done by the ACCC or its predecessors. This chapter instead focuses on three further issues:

- s. 50 and mergers and acquisitions
- s. 46 and predatory pricing
- the former s. 49 and price discrimination.

In relation to each of these issues, this chapter will examine:

- the provision of the Act
- submissions made by interested parties
- arguments for and against amending the Act.

19.2 Mergers and acquisitions

During the inquiry, some market participants expressed concern about mergers and acquisitions, and in particular creeping acquisitions, by the major MSCs, Coles and Woolworths. For example, the National Association of Retail Grocers of Australia (NARGA) submitted that:

> Market share growth by Woolworths and Coles has been the result of (factors including)… "creeping"—store by store—acquisition of successful independent stores by Woolworths and Coles.[1]

The term 'creeping acquisition' generally refers to the practice of making a series of acquisitions over time that individually do not raise competitive concerns, usually because the changes in competitive rivalry from any individual acquisition are too small to be considered a substantial lessening of competition. However, when taken together, the acquisitions may have a significant competitive impact. The term creeping acquisition might also refer to a player with existing market power making a small acquisition, even though the small acquisition does not substantially lessen competition in itself.

Creeping acquisitions may be a concern when they occur in a market where the structure of that market facilitates the exercise of market power, and in particular, where that market is characterised by high barriers to entry or expansion.

The following discussion focuses on acquisitions by the MSCs. There have also been a large number of mergers and acquisitions, involving companies that provide wholesaling services to independents, which ultimately led to the formation of Metcash. They were previously discussed in detail in chapter 7, which examined the competitive position of independents supplied by Metcash.

19.2.1 Submissions on mergers and acquisitions in the grocery industry

Some interested parties submitted that creeping acquisitions are occurring in the retail grocery industry and are having a detrimental effect on competition.

Concerns have been raised that creeping acquisitions have the potential to directly affect competition in grocery retailing by eliminating or preventing competition from other grocery retailers:

> … creeping acquisition tactics of the majors has further extinguished the scope for the development of independent groups.[2]

Further concerns have been raised that, collectively, retail acquisitions may also affect the grocery wholesaling sector and have a flow-on effect on grocery retailing. Industry participants submitted that grocery wholesalers can potentially suffer two sources of competitive disadvantage from acquisitions in grocery retailing:

- loss of economies of scale in wholesaling relative to the MSCs (see chapter 8 for further discussion of economies of scale in wholesaling)
- loss of bargaining power in negotiations with suppliers relative to MSCs.

Metcash submitted that:

> … creeping acquisitions are extremely detrimental to the maintenance of competitive forces in the retail market—when an MSC acquires an independent retailer in an area, not only is there a

1 NARGA, submission no. 129, p. 3.

2 Koundouris Group, submission no. 35, p. 4.

reduction in the level of choice available to consumers in the area, but the entire cost base of the independent sector is also undermined due to the corresponding loss in economies of scale, scope and density.[3]

Some participants also expressed concerns that the growth of MSCs through acquisitions may increase the MSCs' buying power and have a detrimental impact on suppliers (see chapters 15 and 16 for further discussion of buyer power).

Concerns about creeping acquisitions stemmed from a view that s. 50 of the Act, the regulatory tool for reviewing mergers and acquisitions, does not enable the ACCC to assess the accumulated competitive impact of a series of acquisitions over time:

> Small businesses argue that the nature of the TPA and its application means that minor or so called "creeping acquisitions" by MGRs (major grocery retailers), (ie. purchases of existing independently-owned stores or the opening of new stores) are not precluded or actively prevented.[4]
>
> We are concerned about the potential competition problems that result from 'creeping acquisitions'. We continue to be concerned that section 50 may not be sufficient to deal with this issue.[5]

Organisations such as CHOICE called for amendments to s. 50 to ensure that consideration is given to any accumulated competitive impact:

> Choice supports a review of the ACCC's competition powers in relation to dealing with creeping acquisitions … Small acquisitions of additional stores which in themselves don't raise a competition problem should be looked at on an aggregate basis and that accordingly there needs to be some change to the law in relation to how those issues are dealt with.[6]

NARGA submitted that it may be appropriate that there be further amendments to the Act to provide greater scrutiny of mergers and acquisitions in the grocery retail sector.[7]

NARGA suggested the introduction of a 'competition test' to assess local market concentration before the approval of any acquisition or development application.[8] A test of this nature was recommended by the Competition Commission as part of the recent investigation into the supply of groceries in the UK.[9] Such a test would prohibit the acquisition of existing stores or development of new stores by a market operator where the overall presence of that operator in a defined local market exceeded a certain threshold.

The Koundouris Group[10] and the Master Grocers Association (MGA)[11] also suggested limitations on MSCs opening new stores in markets where they already have a presence. The MGA, however, acknowledged that restrictions of this nature can adversely affect smaller market participants:

> It should be noted that increased regulation of creeping acquisitions may sometimes have a negative effect, albeit limited, on independent supermarkets. Restricting the ways in which the major chains can appropriate individual independent stores could decrease the potential exit pathways for independent supermarket owners wishing to sell their businesses. Indeed, increased regulation of creeping acquisitions acts to limit the growth of the chains market share rather than stimulate the introduction of new independent stores to the market place.[12]

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3 Metcash, submission no. 181, p. 39.
4 NARGA, submission no. 14, attachment by PricewaterhouseCoopers, p. 22.
5 Consumer Action Law Centre, submission no. 124, p. 11.
6 ACCC, public hearing transcript, Sydney, 1 April 2008, p. 7.
7 NARGA, submission no. 129, p. 6, 35–6; NARGA, submission no. 159, p. 11.
8 NARGA, submission no. 129, p. 36.
9 Competition Commission, The supply of groceries in the UK market investigation, volume 1: summary and report, April 2008, p. 17.
10 Koundouris Group, submission no. 35, p. 4.
11 Master Grocers Australia, submission no. 96, p. 10.
12 ibid.

Coles submitted that s. 50 allows the ACCC to fully investigate the competitive impact of a supermarket acquisition:

> While arguments have been raised that the Act is not effective against preventing creeping acquisitions, Coles notes that the Commission uses a forward-looking test which may allow the Commission to consider past and current acquisitions when assessing the likely effect of an acquisition on competition.[13]
>
> Coles … considers that the current prohibition on mergers and acquisitions as contained in section 50 of the Act works effectively in maintaining a healthy competitive environment.

Coles also submitted that there would be potential adverse impacts on market participants and consumers as a result of additional regulation:

> Prohibiting creeping acquisitions may result in the removal of an exit path for independent operators wishing to sell their business and, as noted by the Commission, does not address increases in market shares through organic growth.
>
> Moreover, care needs to be taken not to overlook the consumer in this issue - either in terms of alleged creeping acquisitions or in some of the more unusual suggestions of market share caps. The process of acquisitions, whether at a store or broader level, can lead to a more efficient business operation or better goods and services to a consumer. It would seem unfair and inappropriate to arbitrarily prevent consumers enjoying the benefits of an acquisition of a grocery store where it leads to a preferred outcome for consumers in terms of products or services.[14]

Woolworths submitted that any additional regulatory burden would add to development times and cost of new supermarkets:

> … in terms of do we need to have a whole host of other tests that would need to be tested in court and subject to appeal, it would just add to the length of development and would actually add to the cost of that development which naturally is going to be recouped over time.[15]

Woolworths submitted that there was no creeping acquisitions strategy being followed by the MSCs and that most of its growth had been through 'organic' growth such as conversion of non-supermarket retail sites, development of greenfield sites or moving store locations.[16]

Woolworths also submitted that regulatory reform may detrimentally affect the competitive process:

> Regulatory reform that leads to a limitation on the range of potential buyers of independent supermarkets through reducing the ability of Woolworths and other major supermarket chains to bid for such businesses would detrimentally affect the competitive process that currently exists under the Charter for the Acquisition of Independent Supermarkets. In particular, two outcomes are likely to result:
>
> - Metcash may become a monopsonist in the market for the acquisition of existing and future IGAs, an outcome which will not likely increase the welfare of independent grocery retailers or their customers; and
> - the value that independent grocery retailers could obtain upon exiting the business would diminish (because of the smaller number of potential bidders), which would ultimately discourage entry into independent grocery retailing because of a perceived inability to adequately execute a financially viable "exit strategy" should the retailer choose to cease trading.[17]

Woolworths also noted the existence of the Charter for the Acquisition of Independent Supermarkets

13 Coles, submission no. 225, pp. 25–26.
14 Coles, submission no. 226, p. 26.
15 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 7.
16 Woolworths, submission no. 232, p. 1.
17 Woolworths, submission no. 232, p. 4.

and Produce and Grocery Industry Code of Conduct.[18]

19.2.2 ACCC view on mergers and acquisitions in the grocery industry

Section 50 of the Act prohibits a corporation from acquiring shares or assets if the acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in a market.

Under s. 50 the ACCC has reviewed a number of supermarket acquisitions notified to it voluntarily over the last 10 years. The ACCC can, under s. 50, oppose an acquisition (or accept a remedy to resolve its competition concerns) where it has been able to establish that an acquisition, on its own, has the likely effect of substantially lessening competition in a market.

Application of s. 50 to single acquisitions

Aside from the issue of creeping acquisitions, there has also been interest during the inquiry concerning how the ACCC generally approaches the application of s. 50 to single acquisitions of supermarkets. A single acquisition can be an acquisition of only one supermarket or an acquisition of a number of supermarkets at one time.

Recent ACCC assessment of single acquisitions

The ACCC's view is that where a single acquisition has significant competitive implications in a local retail area, it can be assessed under s. 50. Where there are a relatively small number of supermarkets in a retail area, an acquisition of one supermarket may have a substantial impact on competition within that area, and can be assessed accordingly. For example, on 25 June 2008 the ACCC opposed Woolworths' proposed acquisition of the Karabar supermarket in Queanbeyan, New South Wales.[19] This acquisition was opposed on its own merits, based on an analysis of local retail and wider wholesale markets, and not on a 'creeping acquisitions' approach. It does not reflect any significant change in the ACCC's approach to acquisitions. The ACCC will oppose acquisitions where it forms the view that there will be a substantial lessening of competition.

Several factors were important in the ACCC considering that a substantial lessening of competition was likely if the Karabar transaction went ahead:

- the concentration of Woolworths stores in the local market
- barriers to entry, including access to suitable sites in the local market that would allow for expansion by competitors to Woolworths
- the likelihood of a strong competitive outcome if the acquisition by Woolworths did not go ahead (the 'counterfactual scenario' or the 'future without the transaction'). In this case, the ACCC had strong evidence to support a likely counterfactual scenario of an acquisition by an independent that would compete strongly with Woolworths and other players in the local market.

The ACCC analysed the Karabar transaction, as it has with other supermarket transactions in the past, based on an assessment of local retail and wider wholesale markets. It is in these markets that any anti-competitive effects are likely to be felt. For instance, in a local retail market, an anti-competitive acquisition by an MSC can lead to less competition on prices and service, and may lead to less innovation or dynamism in offerings to consumers who shop in that local market.

Wholesale market analysis was conducted for the Karabar transaction, but was not a deciding factor

18 Woolworths, submission no. 232, p. 1.

19 ACCC, *ACCC opposes the proposed acquisition of Karabar supermarket by Woolworths Limited*, media release, 25 June 2008.

in the ACCC's decision to oppose the acquisition. When assessing wholesale markets, the ACCC is interested in the effect that acquisitions may have on the ability of competitors at the wholesale level to compete in their supply to the independent supermarkets. As the number of supermarkets the wholesale competitors supply in a given wholesale market (and the consequent scale of purchases made by them) diminishes, the costs per item supplied for the wholesalers may increase and their ability to be competitive decline. As an acquisition of an individual supermarket by an MSC is unlikely to have a substantial impact on competition at the wholesale level, the focus of the ACCC's competition assessments when examining supermarket acquisitions tends to be on local market impacts.

While there is no specific reference to 'local market' in the Act, the ACCC has always considered such markets are capable of being 'substantial' markets, as required by s. 50. [20] The ACCC has considered whether a new local competition test for supermarkets needs to be inserted into the Act to remove any doubt over this issue but, given its view that 'local' markets are capable of being 'substantial' markets, the ACCC does not consider that such a change is needed at this stage. The ACCC has never had its view challenged, nor has the issue been tested in the courts. If it were ever found by a court that local markets were not capable of being 'substantial', then the ACCC would recommend that the government amend the legislation to make it clear that local markets can be considered in the context of the s. 50 substantial lessening of competition standard.

The ACCC also considers that acquisitions of larger supermarket chains can be assessed under s. 50. In 2005 the ACCC conducted a major investigation of the sale of Foodland Associated Limited's (FAL) supermarket and wholesaling business. This investigation examined Woolworths' proposed acquisition of 22 Action supermarkets and development sites in Western Australia, Queensland and New South Wales; and Metcash's proposed acquisition of the remaining 60 Action supermarkets and FAL's wholesale distribution business. In 2001 the ACCC conducted a major investigation into the sale by Dairy Farm of the 287 supermarkets in its Franklins chain to companies including Pick 'n Pay, Woolworths and Metcash.

It is relevant to note that s. 50 prohibits an acquisition that results in a substantial lessening of competition relative to a counterfactual situation without the merger or acquisition. For example, regarding the Franklins sale, the counterfactual was that Franklins had not been a successful business and competitive force in the period leading up to its sale and this was likely to continue into the foreseeable future if the acquisition did not proceed.

In addition to the Foodland investigation, the ACCC has publicly reviewed nine transactions involving nine supermarkets over the last three years.[21]

Notification of acquisitions

Review of the above proposed transactions occurred after they were brought to the ACCC's attention. However, it should be noted that notification of proposed acquisitions is not compulsory. Mandatory notification of proposed acquisitions was recommended in the Baird report by the Joint Select Committee on the Retailing Sector in 1999.[22] The Produce and Grocery Industry Code of Conduct—a voluntary code introduced by the Australian Government in 2000 to which both Coles and Woolworths

20 Section 50(6) states that the word 'market' is defined to mean 'a substantial market for goods or services in: Australia, a state; a territory; or a region of Australia'.

21 A full list of public merger reviews conducted by the ACCC about supermarket acquisitions over the last three years is included in appendix F.

22 Joint Select Committee on the Retailing Sector, *Fair market or market failure: a review of Australia's retailing sector*, Parliament of the Commonwealth of Australia, Canberra, 1999.

are signatories—states that the ACCC is to be notified of acquisitions of a controlling interest in a grocery retailer.[23] Despite the requirements of the code, the ACCC is aware of a small number of acquisitions over this period where it has not been notified.

Application of s. 50 to creeping acquisitions

While s. 50 of the Act applies to individual acquisitions, the application to potential 'creeping acquisition' issues is more problematic. The ACCC takes the view that, while it can assess under s. 50 the competitive issues associated with an individual acquisition, s. 50 is unlikely to allow it to examine the cumulative impact of a series of acquisitions of smaller competitors over time that individually do not raise competition issues. Section 50 is unlikely to be able to deal with such acquisitions because, among other things:

- s. 50 expressly refers to a single acquisition only
- ss. 45 and 47 contain provisions expressly allowing the examination of multiple transactions, while s. 50 does not.

The ACCC has previously examined the issue of creeping acquisitions in the supermarket industry, most recently in its 2004 inquiry into the effects of shopper docket discounts and acquisitions in the petrol and grocery sectors.[24] The ACCC recognised the challenges that creeping acquisitions presented and, although it did not find any evidence that such acquisitions raised competition concerns in the grocery industry at that time, it recognised the potential for issues to arise.

Following the 2004 inquiry, the ACCC also introduced the voluntary Charter for the Competitive Sale of Independent Supermarkets in July 2005.[25] This charter was designed to address concerns over exclusive negotiation clauses being placed in contracts for the acquisition of independent supermarkets by MSCs. Metcash, Coles, Woolworths and Franklins are all parties to the charter.

Under the charter, acquiring parties cannot prevent independent supermarket retailers from seeking alternative purchasers for their stores after receiving a purchase offer, and must make sure that the target store owners are aware of their rights under the charter.[26] Available information suggests that the charter has generally been complied with to date.

The ACCC notes concerns raised by some industry participants that the cumulative effects of individual acquisitions have been significantly detrimental to competition in grocery retailing. However, none of the submissions making that claim identified specific markets where there had been a substantial lessening of competition as a result of a series of acquisitions. The ACCC has not been able to identify any supermarket acquisitions in the last five years where the result would have been different had the ACCC been able to take into account other acquisitions in the same market. This suggests that the cumulative effect of a series of acquisitions of independent supermarkets by the MSCs has not been a significant contributor to any competition problems in the supermarket sector in recent years.

Submissions and information obtained during the inquiry show that acquisitions of existing retail grocery businesses over the past 15 years have to some extent contributed to the growth of MSCs. However, the main source of growth has occurred through the development of new retail sites. It is also notable that a significant proportion of growth through acquisition of existing retail businesses is attributable to

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23 Produce and Grocery Industry Code of Conduct, December 2007, clause 8, available at www.produceandgrocerycode.com.au/. Acquisition in the code is defined as acquiring a controlling interest in a retailing entity trading in the retail grocery trade within Australia.

24 ACCC, *Assessing shopper docket petrol discounts and acquisitions in the petrol and grocery sectors*, February 2004. pp. 26–29, 41–42.

25 ACCC, *ACCC announces charter to promote competitive sales of independent supermarkets*, media release, 1 July 2005.

26 However, under clause 5 of the charter, a party may enter into an agreement to supply an independent supermarket retailer that contains a restriction on sales to third parties if the party has provided assistance to the independent supermarket retailer.

two transactions, the sale of Franklins in 2001 and Foodland in 2005, rather than through a series of acquisitions of smaller independent supermarkets by the MSCs.

Table 19.1 sets out the proportion of supermarkets opened by Coles and Woolworths, over the last 15 years, on sites previously operated by a competing grocery retail business compared to the development of new sites.

Table 19.1 Coles and Woolworths—store openings in the past 15 years

	1993–97	1998–2002	2003–05	2006–07	Overall
Development of a new site	73%	46%	67%	90%	61%
Site previously occupied by a supermarket: Franklins and Action acquisitions	—	21%	13%	—	13%
Site previously occupied by a supermarket: store openings other than the Franklins and Action acquisitions*	27%	33%	20%	10%	26%

*Note: this figure is likely to slightly overstate the level of acquisitions of single independent stores because it includes a small number of acquisitions of small supermarket chains; for example, Woolworths' acquisition of nine Cannons stores in 1996.

Based on this data, an overwhelming proportion of new growth for MSCs over the last five years has come from the development of new sites. This preference of the MSCs for the development of new sites is even more pronounced over the last two years, accounting for 90 per cent of store openings.

Although the MSCs have had substantial growth in store numbers over the last 15 years, including through acquisitions of competing businesses, they have not increased their share of grocery retail stores around or above 1000 m^2. Their growth has approximately been matched by the expansion of ALDI and independent grocery retailers (see chapter 3). However, although there are a substantial number of supermarkets above 1000 m^2 competing with the MSCs, most of these are mid-sized (between 1000 m^2 and 2000 m^2) rather than large format supermarkets. In comparison, around 60 per cent of MSC stores are above 3000 m^2 in sales area and the MSCs have a stated preference for larger stores. The MSCs therefore would likely have increased their share of total grocery retailing floor space over this period.

Application of s. 50 to the acquisition of new sites

The inquiry has also revealed a misconception held by some industry players that the ACCC can only analyse transactions where there is an acquisition of an existing supermarket business. This is incorrect.

The ACCC considers that leases of sites, acquisitions of leases currently held by other parties and acquisitions of sites that are currently empty or used for other purposes can all be considered acquisitions of assets under s. 50 or other provisions in Part IV of the Act. The ACCC has reviewed acquisitions of development sites in the past, but has not found any acquisition in breach of s. 50. For instance, the ACCC conducted an analysis of the effect of Woolworths acquiring several development sites as part of its consideration of the Foodland Associated Limited transaction in 2005.[27] The ACCC

27 ACCC, public competition assessment, Woolworths' proposed acquisition of 22 Action stores and development sites (19 October 2005), www.accc.gov.au.

will continue to review such acquisitions of sites or leases for the future development of supermarkets if it is brought to its attention that there are competition issues associated with those acquisitions.

It is important to note that many proposals involving the acquisition or establishment of new supermarket sites (that is, where there is an acquisition or lease of a site that did not previously operate as a supermarket, as opposed to the acquisition of an existing supermarket) are not likely to raise significant concerns under the substantial lessening of competition standard in Part IV of the Act. Generally speaking, such new supermarket developments are unlikely to harm competition and are more likely to be pro-competitive. There will only be isolated circumstances where the evidence put before the ACCC indicates that a substantial lessening of competition is likely. The ACCC will tend to focus on those new developments where:

- the site is in a built-up area where there is limited availability of alternative sites for potential competitors in the local market
- the proposed supermarket operator already has a significant presence in the local market, and
- if the proposed supermarket did not open on the site, then an alternative competitive supermarket would be likely to open on that site.

The ACCC has written to the MSCs, major independents and significant retail landlords, to reiterate that s. 50 applies to leases or acquisitions of empty sites and non-supermarket sites, as well as the acquisition of existing supermarket businesses. The ACCC has encouraged acquirers of such sites to act prudently and advise the ACCC in advance if any such acquisitions may give rise to potential competition concerns.

As there is no compulsory notification merger regime in Australia, the ACCC encourages parties who have concerns about particular acquisitions of new supermarket sites to advise the ACCC. The ACCC can then consider whether there are competition concerns that warrant review under s. 50. The ACCC would expect parties who have concerns about an acquisition to put to the ACCC credible evidence that the 'counterfactual scenario' (that is, the future without the proposed acquisition) is likely to involve a competitive supermarket opening on the site. Credible evidence would include where an independent supermarket identifies well-progressed plans to develop a large-format and competitive supermarket in a built-up area, but one of the MSCs (which already has one or more supermarkets in the local area) secured the necessary rights to develop the site instead.

Overall ACCC view

Section 50 of the Act allows the ACCC to review individual acquisitions of supermarkets on their own merits based on analysis of local retail and wider wholesale markets, not on a creeping acquisitions approach. The ACCC's recent opposition to Woolworths' proposed acquisition of the Karabar supermarket was based on a conventional single acquisition analysis. The ACCC considers that local retail markets are capable of being 'substantial' markets for the purpose of s. 50 of the Act.

However, the ACCC considers that s. 50 is unlikely to be able to deal with the cumulative impact of acquisitions of smaller independent supermarkets that individually do not raise competition issues.

The ACCC considers that such acquisitions do not appear to be a significant current concern in the supermarket retailing industry. Most of the new growth by MSCs in recent years has not come from acquisitions of independent supermarkets. No specific evidence has been provided to show that acquisitions of existing businesses have caused significant competitive detriment in the grocery industry in recent years.

Although such acquisitions do not appear to be a significant current concern in the supermarket retailing industry, the ACCC maintains its support for the introduction of a general creeping acquisition law. The ACCC considers that the supermarket industry is one where creeping acquisitions could potentially become a concern, due to particular structural features of the market, including:

- the need to obtain good sites being a significant barrier to entry, particularly given the financial resources of the MSCs and the leverage they wield over lessors of suitable sites
- the existence of broader barriers to entry and expansion created through the need to obtain economies of scale and efficient wholesaling operations
- the existence of two major supermarket chains
- a situation where there are many small business units (that is, retail stores or potential retail sites) that could be acquired or leased one by one or in small groups.

The ACCC can consider all acquisitions of assets, including leases of sites, acquisitions of leases currently held by other parties and acquisitions of sites that are currently empty or used for other purposes. However, many proposals involving the acquisition or establishment of new supermarket sites, as opposed to the acquisition of an existing supermarket, are unlikely to raise significant concerns under the Act.

The information the ACCC has received throughout the inquiry has been and will continue to be of significant assistance in analysing proposed transactions and supermarket developments. The inquiry has emphasised the high level of barriers to entry and expansion in grocery retailing due to the difficulty in obtaining large and well-located supermarket sites.

19.3 Predatory pricing

Predatory pricing, particularly against independent retailers by the MSCs, has been raised as a concern during this inquiry. Predatory pricing occurs, broadly, when a company sets its prices at a sufficiently low level with the purpose of damaging or forcing a competitor to withdraw from the market.

Section 46 of the Act is the key provision that addresses behaviour that may constitute predatory pricing, although it does not deal with predatory pricing exclusively. Under s. 46 corporations with a substantial degree of market power are prohibited from taking advantage of that market power for an anti-competitive purpose. The recent Birdsville amendment to s. 46, and in particular s. 46(1AA), prohibits a firm with a substantial market share from undertaking sustained below-cost pricing for an anti-competitive purpose.

This provision is designed to protect and foster competition in Australian markets. Importantly, however, it does not exist to shield inefficient business operators from the rigours of fair competition, or prohibit below-cost pricing outright.

19.3.1 Submissions

During the inquiry the ACCC has heard broad allegations of the MSCs engaging in predatory pricing directed at independent retailers operating in their local area. However, apart from these broad allegations, the ACCC has only been presented publicly with a small number of specific allegations of predatory pricing. As discussed further below, the ACCC considers that these specific allegations of predatory pricing fall short of conduct prohibited by s. 46. Confidential submissions raising predatory pricing allegations have also been investigated in an appropriate manner.

Many of the specific allegations provided to the ACCC were borne out of a misunderstanding of the legal concept of predatory pricing. In particular, many of the concerns related to instances of vigorous price competition by the MSCs that independent retailers struggled to match. Such vigorous price competition in itself would not ordinarily raise concerns under the Act. The ACCC notes that vigorous price competition is generally likely to be pro-competitive and deliver benefits to consumers. The specific examples are discussed in further detail below.

General submissions

A number of interested parties submitted that predatory pricing conduct was an issue. For example, FoodWorks submitted that MSCs will, on entering an independent's catchment area, reduce prices on top-selling products and then, 'once the independents business become [sic] non-viable and closes, the MSC have the ability to put prices up again.'[28] It further submitted that there 'have been numerous examples over the years of what we would maintain have been predatory tactics to force smaller retailers out of business or to sell out'.[29] Brismark also submitted that independent retailers were at risk of predatory pricing by the MSCs.[30] The Master Grocers Association (MGA) submitted that 'current market divisions also give rise to predatory pricing concerns'.[31] Harris Farm markets submitted that it had evidence of predatory pricing behaviour by the MSCs.[32]

Various interested parties, including FoodWorks, NARGA, the MGA and the National Farmers Federation (NFF) submitted that there have been significant problems in the application of s. 46 to instances of alleged predatory pricing, that possible examples of predatory pricing could not be made out under the existing s. 46 and/or that changes needed to be made to s. 46 to better address issues relating to predatory pricing.[33]

The MGA stated that 'there are always certain difficulties with distinguishing between anti-competitive pricing, aimed at eliminating competitors or raising barriers to entry, and competitive pricing designed to benefit the consumer and legitimately compete in the market.'[34] It submitted that the 'legislation would be of more assistance with specific reference to predatory pricing, particularly firmer guidelines as to how to distinguish competitive pricing from predatory pricing, and how to view below cost pricing in this respect.'[35]

Interested parties such as NARGA noted the Birdsville amendments to s. 46 as stating an important principle that predatory pricing conduct is not acceptable. However, NARGA submitted that demonstrating 'substantial share of a market' and an offer 'for a sustained period of time' of a product at a price 'below the relevant cost of supply' for an anti-competitive purpose would be difficult to prove.[36] In contrast, the NFF supported those amendments to s. 46.[37]

A submission from William Edwards expressed the view that the low pricing of fresh produce in Woolworths' Fresh Food People campaign was predatory pricing.[38]

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28 Australian United Retailers Limited (FoodWorks), submission no. 90, p. 27.

29 Australian United Retailers Limited (FoodWorks), submission no. 90, p. 38.

30 Brismark, submission no. 68, p. 16.

31 Master Grocers Association, submission no. 96, p. 7.

32 Harris Farm Markets, submission no. 227, p. 3.

33 Australian United Retailers Limited (FoodWorks), submission no. 90, p. 40; Master Grocers Association, submission no. 96, p. 7; NARGA, submission no.129, p. 6, 37; National Farmers Federation, submission no. 137, p.13.

34 Master Grocers Australia, submission no. 96, p. 7

35 Master Grocers Australia, submission no. 96, p. 7

36 NARGA, submission no. 129, p 37

37 National Farmers Federation, submission no. 137, p. 13.

38 William Edwards, submission no. 229, p 9.

Specific examples

The ACCC received a limited number of submissions about specific allegations of predatory pricing.

FoodWorks submitted that, following rationalisation of the grocery sector, there is no longer a need for sustained predatory conduct by the MSCs. However, in contrast, it also submitted that the MSCs' selling of Victoria Bitter beer from Fosters could be considered an example of possible predatory pricing.[39] FoodWorks submitted that the MSCs sold the product at 10 per cent below cost. The WA Independent Grocers Association (WAIGA) also submitted that an example of predatory pricing had occurred in the mid-1990s in Bunbury.[40]

The ACCC is not considering the sale of liquor in the course of this inquiry, but can consider allegations of predatory pricing in the course of its normal functions. In relation to the mid-1990s Bunbury example raised by WAIGA, the ACCC considers that given the age of the example it will not follow up that allegation further.[41]

NARGA made submissions raising allegations of predatory pricing by a Woolworths store in Cootamundra. [42] Specifically, the concerns related to a six to eight week period starting in February 2008 where it was alleged that Woolworths had advertised and offered deeply discounted prices on some items in response to the upgrading and refurbishment of an IGA store. The Koundouris Group also provided another example, previously raised with the ACCC, of similar conduct relating to the opening of a Supabarn store in Wanniassa.[43]

The ACCC has examined both of these allegations of predatory pricing, and in so doing has used the information-gathering powers available to it under the Act. The ACCC sought information from Woolworths about the pricing policies of its Cootamundra store and the costs of supplying the discounted products over the period of the promotion. Although the information provided suggests that Woolworths sold some of the relevant goods at below its cost of supply, the ACCC notes that this only occurred for a limited period, the purpose of which was to vigorously compete with a refurbished store reopening. The information did not suggest that the conduct was directed at or could have resulted in eliminating, or substantially damaging, the newly refurbished competitor. The Wanniassa complaint was similarly related to conduct for a limited period relating to the opening of a competing store.

Woolworths stated that its advertising strategy for the Cootamundra store was consistent with its general practice and that of its competitors. This practice is that, when a new store opens in a local area, specific specials are offered by existing stores for a number of weeks in an attempt to maintain their customer base.[44]

In its hearing evidence, NARGA stated that it was aware of two other locations where concerns regarding predatory pricing had been raised in recent months.[45] After the hearing the ACCC contacted NARGA and requested that it provide details of these two locations. NARGA responded that there

39 Australian United Retailers Limited (FoodWorks), submission no. 90, p. 40.

40 WA Independent Grocers Association, submission no. 89, p. 13.

41 Section 77 of the Act sets a six-year time limit for the ACCC to seek a pecuniary penalty for conduct in breach of Part IV (there is an equivalent six-year limit on damages actions: s. 82). Given the age of the complaint, the six-year period has expired. The ACCC would be able to seek relief, such as an injunction or order in relation to the conduct (s. 87), but there is limited benefit from those remedies for conduct which has ceased. The ACCC also notes the significant evidentiary problems that would arise with investigating a complaint of this age.

42 NARGA, submission no. 129, p. 69; ACCC, public hearing transcript, Canberra, 9 April 2008, p. 12.

43 Koundouris Group, submission no. 35, p. 3.

44 ACCC, public hearing transcript, Melbourne 19 May 2008, pp. 99–100.

45 ACCC, public hearing transcript, Canberra, 9 April 2008, p. 14.

were at least two other sites where predatory pricing concerns had been raised, but that it did not have details of which stores were involved.

A further example of alleged predatory pricing was put to the ACCC which alleged that Woolworths had engaged in the below-cost selling of a fruit item in a store that was directly competing with a fresh fruit and vegetable retailer. The evidence available to the ACCC suggested that while there was below-cost selling of the item occurring for some of the period in question, it was not for a sustained period or for the purpose of eliminating or substantially damaging a competitor. The ACCC considers that below-cost pricing of a single product is generally unlikely to have significant effects on a competitor, unless it is a very significant product. In this case the product made up less than one-tenth of 1 per cent of the Woolworths supermarket's annual sales, although the ACCC notes that sales of that product may have been a larger proportion of sales for the competitor.

19.3.2 Predatory pricing and the role of s. 46

Current legislation

Before the recent amendments to s. 46 in 2007 there were no provisions in the Act which specifically addressed predatory pricing concerns. However, in 2003 the High Court in the case of *Boral Besser Masonry v ACCC* did consider alleged predatory pricing behaviour in the context of s. 46(1) of the Act.[46] Section 46(1) states that a corporation with a substantial degree of market power shall not take advantage of its power for three proscribed purposes. It provides:

> A corporation that has a substantial degree of power in a market shall not take advantage of that power in that or any other market for the purpose of:
>
> a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;
>
> b) preventing the entry of a person into that or any other market; or
>
> c) deterring or preventing a person from engaging in competitive conduct in that or any other market.

On 25 September 2007, as part of a number of amendments to s. 46, s. 46(1AA) came into effect with the purpose of 'targeting anti-competitive below-cost pricing by corporations with a substantial market share.'[47] This provision has become known as the 'Birdsville amendment'. Section 46(1AA) provides that:

> A corporation that has a substantial share of a market must not supply, or offer to supply, goods or services for a sustained period at a price that is less than the relevant cost to the corporation of supplying such goods or services, for the purpose of:
>
> a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;
>
> b) preventing the entry of a person into that or any other market; or
>
> c) deterring or preventing a person from engaging in competitive conduct in that or any other market.

46 *Boral Besser Masonry v ACCC* (2003) 215 CLR 374.

47 Trade Practices Legislation Amendment Bill (No.1) 2007, supplementary explanatory memorandum, p. 1.

A new s. 46(4A) was also enacted as part of the Birdsville amendments. This provision sets out certain matters a court may consider when assessing an allegation of predatory pricing under s. 46(1). Section 46(4A) contains terms that are also used in s. 46(1AA). Section 46(4A) provides:

> Without limiting the matters to which the Court may have regard for the purpose of determining whether a corporation has contravened subsection (1), the Court may have regard to:
>
> a) any conduct of the corporation that consisted of supplying goods or services for a sustained period at a price that was less than the relevant cost to the corporation of supplying such goods or services; and
>
> b) the reasons for that conduct.

As a consequence of the 2007 amendments, the ACCC may consider allegations of predatory pricing under two provisions of the Act—s. 46(1) and s. 46(1AA). The two provisions have similarities but also significant differences. The first significant difference is that:

- s. 46(1) prohibits certain conduct by a corporation with substantial market **power**
- s. 46(1AA) prohibits certain conduct by a corporation with substantial market **share**.

Although potentially related, market power and market share are distinct legal concepts.

The second significant difference is that s. 46(1) states that a corporation must not 'take advantage' of its market power. This term does not appear in s. 46(1AA), which instead states that a corporation with substantial market share must not supply for a 'sustained period' at a price below 'relevant cost'.

Both ss. 46(1) and 46(1AA) prohibit a corporation from acting with one of the three anti-competitive purposes. Under both sections, the market that is the subject of a corporation's anti-competitive purpose does not have to be the market in which the corporation has substantial market power or market share.

Proposed changes to the current Act

On 26 June 2008, the government introduced the Trade Practices Legislation Amendment Bill 2008 to parliament. Among other proposed amendments to the Act, this Bill proposes a number of amendments to s. 46. These include:

- stating that a corporation may be found to have breached s. 46 even if it had no ability to recoup losses from the conduct
- amending s. 46 to clarify the meaning of 'take advantage'
- amending s. 46(1AA) to refer to market power, not market share, and to introduce the concept of 'take advantage' of market power to s. 46(1AA)
- repealing s. 46(4A).

Section 46 is currently silent on the issue of recoupment. The ACCC considers that it is currently unclear whether a firm's ability to recoup losses from predatory pricing (that is, by charging higher prices once competition has been eliminated) is necessary to establish a breach of s. 46. In relation to this recoupment issue, the bill proposes to replace the existing s. 46(1AB) with the following new provision:

> A corporation may contravene subsection (1AA) even if the corporation cannot, and might not ever be able to, recoup losses incurred by supplying the goods or services at a price less than the relevant cost to the corporation of the supply.

The ACCC considers that the proposed amendment is desirable to clarify that a finding of expectation or likely ability to recoup losses is not required to demonstrate a breach of s. 46.

The bill also proposes to introduce the concept of 'take advantage' to the prohibition in s. 46(1AA). The ACCC welcomes this reform as it is likely to help address concerns that genuine competitive pricing behaviour could be inadvertently caught by s. 46(1AA). These concerns arose from the absence of a requirement of a nexus between the existence of the relevant market share and the conduct in question.

By introducing the concept of 'take advantage' into s. 46(1AA), and replacing the concept of 'market share' with 'market power', the bill proposes to make s. 46(1AA) consistent with s. 46(1). The ACCC considers that the current use of both 'market share' and 'market power' in s. 46 creates uncertainty. It will take time for the courts to consider the application of the newly introduced 'substantial market share' concept. However, there is already a significant body of case law about s. 46(1) and the concept of taking advantage of a substantial degree of market power. The replacement of 'substantial market share' in s. 46(1AA) with the concept of 'substantial degree of market power' will remove the uncertainty of having both terms in the Act.

The bill also sets out a non-exhaustive list of matters that a court may consider in determining whether a corporation has taken advantage of its substantial degree of market power. These matters, in the draft s. 46(6A), are:

a) whether the conduct was materially facilitated by the corporation's substantial market power
b) whether the corporation engaged in the conduct in reliance on its substantial market power
c) whether it is likely that the corporation would have engaged in the conduct if it did not have substantial market power
d) whether the conduct is otherwise related to the corporation's substantial market power.

The ACCC has previously advocated the introduction of such a provision, which it considers would clarify that, where a corporation's market power drives its conduct, this will be sufficient to establish that the corporation has taken advantage of its market power.

Together with the other amendments described above, the bill's proposed repeal of s. 46(4A) would remove the dual prohibition of predatory pricing. In effect, s. 46(1AA) will become the provision which specifically prohibits predatory pricing.

ACCC's view on the legislation

Predatory pricing is not a clear or easily defined concept. The difference between predation and genuine competitive pricing behaviour can be a subtle one. The ACCC considers that the existing s. 46(1AA) may run the risk of discouraging genuine competitive behaviour given, in particular:

- the uncertainties introduced by the substantial market share concept
- the lack of requirement of a nexus between the existence of a substantial market share and the conduct in question.

The ACCC considers that the proposed amendments to s. 46 will better allow the ACCC to address examples of actual predatory pricing but not discourage genuine competitive pricing behaviour.

19.3.3 ACCC's view on predatory pricing in grocery retailing

The ACCC recognises that predatory pricing is of concern to a number of participants in the grocery retailing industry and notes that the structure of the industry may create incentives for such conduct to take place. Predatory behaviour could significantly damage the competitive structure of local markets if efficient businesses were targeted. The ACCC accordingly takes alleged predatory pricing conduct seriously.

In addition to forcing out existing efficient competitors, predatory pricing behaviour may also distort new competitive entry and capital outlay by causing incorrect signals about the potential profitability of operating in a particular area. Where a potential competitor may see high potential profits based on existing prices in an area, but on entry is subject to price competition that does not allow a profit, significant capital outlays may be lost.

However, the ACCC considers that no persuasive evidence was provided to the inquiry of attempts by large firms to eliminate smaller efficient firms by engaging in predatory pricing behaviour. Based on the ACCC's analysis of the specific complaints made to it, competitive discounting by the MSCs is often mistaken by smaller competitors for predatory pricing and misuse of market power.

The ACCC notes again that the difference between predatory pricing and genuine competitive pricing behaviour can be subtle. Because of this, predatory pricing (as well as misuse of market power more generally) is not a well understood concept. Firms that struggle to compete with more efficient or innovative rivals may not be well placed to distinguish between fair competition that delivers benefits to consumers and unfair competition. This is particularly the case for smaller firms competing with larger firms that are better placed to exploit economies of scale and sell goods and services at a lower price on an ongoing basis. Given this potential for confusion, the ACCC considers that a number of issues relating to allegations of predatory pricing, and its difference from competitive behaviour, should be clarified.

First, it is important to note that a large supermarket operator who has achieved economies of scale or favourable trading terms from its suppliers may have lower costs of supply than a smaller competitor. When the larger operator supplies goods at a price below that at which the smaller rival can profitably supply the same products (as was the case for the majority of products in the allegation against Woolworths Cootamundra), they have not necessarily breached the Act. The relevant cost of the large operator must be considered rather than that of the alleged victim of the conduct.

Second, the cost of supply is not the only relevant factor in assessing the likely predatory nature of discount pricing. The duration of below-cost pricing must also be considered in distinguishing between legitimate price discounting and anti-competitive predatory pricing. Sections 46(1AA) and 46(4A) (as currently enacted) specifically refer to the supply of goods or services at below cost for a sustained period. A retailer offering a weekend or short-term price special or occasionally reducing its prices to sell excess stocks of perishable goods is most likely engaging in legitimate competitive conduct that should not be discouraged.

Third, the supply of goods for a sustained period below a firm's own cost is not in itself a breach of s. 46. In balancing the competitive benefit to consumers of lower prices with the anti-competitive risks associated with predatory behaviour, the law requires that the alleged predator possesses an anti-competitive purpose behind its discounting. If the purpose of conduct is to temporarily respond to a competitive threat resulting from a new store opening or improved competitor offering, the relevant anti-competitive purpose is unlikely to be present. An imprecisely worded prohibition on predatory pricing may inadvertently deter or capture genuinely competitive discounting and therefore reduce benefits to consumers.

The ACCC notes the conclusions made in chapters 4 and 5 that substantive price competition in grocery retailing principally occurs as competition on KVIs and promotions. Promotional discounting in particular could be restricted by an imprecisely worded prohibition, as such promotions may involve significant reductions in price and occasionally supply below cost.

Deep price discounts can deliver significant benefits to consumers, and a blanket ban on selling below cost could therefore create significant negatives for consumers. Accordingly, the ACCC does not support any blanket prohibitions on selling below cost. The economic literature outlines both theoretical and empirical evidence that suggests that banning such pricing can in fact significantly dampen competition (especially in one-stop retailing) and lead to a reduction in welfare and consumer benefit.[48] Banning such pricing is also argued to lead to a reduction in retailers' incentives to invest in increased efficiency.[49] Finally, there is some evidence that the impact of below-cost pricing on smaller retailers can vary significantly. Some smaller retailers adjoining larger retailers can exploit the increased store traffic generated by the larger store to sell a larger volume of higher value items. This allows them to exploit higher volumes generated in 'niche' products and avoiding direct competition with the larger retailer.[50]

The key challenge for the ACCC in applying s. 46 to predatory pricing complaints is to ensure the section is applied in a manner that captures true predatory pricing conduct without stifling legitimate competitive discounting that will enhance competition. The purpose and duration of below-cost pricing are the key considerations in distinguishing between legitimate price discounting and anti-competitive predatory pricing under s. 46(1AA).

The ACCC has only received a small number of specific predatory pricing complaints during this inquiry and considers that the vast majority of the complaints involved instances of legitimate pricing strategies, which were pro-competitive in nature or were lacking the evidence needed to prove a contravention of s. 46. This can be contrasted with the evidence provided in 1999 to the Baird inquiry, which noted a 'significant body of evidence' regarding predatory pricing in grocery retailing.[51] This perhaps may signal that predatory pricing is less of a concern currently than ten years ago.

Given the lack of evidence that predatory pricing is causing damage to the competitive process in the grocery industry, the ACCC has not made any specific recommendations about predatory pricing arising from this inquiry. However the ACCC continues to advocate broad improvements to s. 46. It supports the proposed amendments that will enact s. 46(6A) and clarify how s. 46(1AA) is to operate, and considers that these changes will better allow it to address actual predatory pricing conduct.

48 See, for example, Organisation for Economic Cooperation and Development (2006), 'Resale below cost laws and regulations', DAF, 23 February 2006.

49 See R Inderst, and T M Valletti (2008), 'Buyer power and the waterbed effect', CEIS research paper no. 107.

50 See for example, A Dukes, V Singh, and T Zhu (2005), 'Local competition and impact of entry by a dominant retailer', mimeo.

51 Joint Select Committee on the Retailing Sector, *Fair market or market failure? A review of Australia's retailing sector*, 1999, executive summary, chapter 6.

19.4 Price discrimination

Price discrimination involves selling the same product to different customers at different prices, where the differences in price do not reflect the differences to the supplier in the cost of serving those customers. Price discrimination has been raised in four different contexts during the inquiry:

- different prices charged in different stores owned by the same MSCs
- suppliers supplying on better terms to the MSCs compared to Metcash and other wholesale operations
- the same wholesaler or supplier supplying some independent retailers with dry groceries on different terms to other independent retailers
- different pricing and labelling of products that are essentially the same.

Price discrimination that had or was likely to have the effect of substantially lessening competition was previously prohibited by s. 49 of the Act, which was repealed in 1995.[52]

19.4.1 Submissions

The ACCC received a number of submissions that commented on price discrimination. The introduction of private label milk products by MSCs was one example cited of better prices being extracted from suppliers by MSCs.[53]

While interested parties acknowledged that not all price discrimination is anti-competitive and should be prohibited, NARGA and the MGA argued that certain price discrimination can nevertheless be detrimental to suppliers, competitors and consumers.[54]

NARGA argued that price discrimination that favours the MSCs can arise in a number of ways. NARGA submitted that price discrimination can disadvantage smaller suppliers when the MSCs force the smaller suppliers to accept a lower price for a product than they would otherwise obtain for supply to other retailers or wholesalers.[55] NARGA submitted that the MSCs are then able to exploit this cost advantage to target competitors in particular areas.[56] NARGA contends that price discrimination can be a form of 'above cost predation' and that 'it is quite clear that price discrimination is undertaken with the intention of injuring or destroying competitors.'[57] Coles denied that it forced suppliers to engage in price discrimination between itself and other retailers.[58]

NARGA submitted that there is a clear benefit in small businesses being able to source products at or near the prices paid by supermarket chains, and to customers being able to pay similar prices for key product lines no matter where they shop.[59] It submitted that any potential economic efficiency gains do not outweigh these clear benefits, and that the views in the Hilmer report, which led to the repeal of s. 49, are accordingly incorrect. NARGA also submitted that a price discrimination provision would not prevent suppliers from providing purchases with genuine discounts that result from lower costs of

52 An unrelated version of s. 49 has subsequently been enacted.
53 ACCC, public hearing transcript, Canberra, 9 April 2008, p. 22.
54 NARGA, submission no. 129 , p. 37; Master Grocers Association, submission no. 96, p. 8.
55 NARGA, submission no. 129, p. 38.
56 NARGA, submission no. 129, p. 39.
57 NARGA, submission no. 129, p. 39.
58 Coles, submission no. 225, p. 34.
59 NARGA, submission no. 129, p. 42.

supply. In support of its position, NARGA cited examples of laws prohibiting price discrimination from the EU, UK and USA. It submitted that the former s. 49 should be reinstated or that a similar provision should be enacted.[60]

The Southern Sydney Retailers Association (SSRA) submitted that Australia is one of the few countries without any effective prohibition against price discrimination, and that this has resulted in the deterioration of Australia's international competitiveness and consumers paying higher prices.[61] The SSRA contended that smaller independent retailers are 'suffering from price discrimination where they cannot obtain their business inputs at a competitive price.'[62]

The SSRA also submitted that geographic price discrimination, where consumers may pay different prices for goods in different regions, should be prohibited in Australia.[63] In support the SSRA referred to the Canadian Competition Act, which prohibits geographic price discrimination that has the effect or tendency of substantially lessening competition, and which the SSRA submitted had proven successful in Canada in controlling inflation.[64]

The MGA submitted that there was some reasonable concern about the bargaining power of the MSCs and the potential for power in the retail market to be exerted in upstream markets.[65] In particular, the MGA submitted that the MSCs are forcing suppliers to charge lower prices to the MSCs, leading the suppliers to increase the prices they charge to independent retailers or wholesalers. It submitted that this in turn may reduce the competitiveness of independent retailers. Although the MGA acknowledged the potential for s. 46 to address such anti-competitive price discrimination, it submitted that a prohibition on price discrimination should nevertheless be re-enacted.[66]

Dee Margetts submitted that the repeal of the prohibition against price discrimination had constituted a weakening of the Act.[67] Margetts submitted that the repeal of s. 49, along with other changes, had in practice strengthened the market power of the MSCs and also provided them with incentives to abuse market power and allowed them to increase market share.

19.4.2 Background on the repealed s. 49

Under the now-repealed s. 49, a corporation was prohibited from discriminating between purchasers of goods of like grade and quality in relation to:

- the prices charged for the goods
- any discounts, allowances, rebates or credits given or allowed in relation to the supply of the goods
- the provision of services in respect of the goods or
- the making of payments for services provided in respect of those goods
- where the discrimination was of such magnitude or of such a recurring or systematic character that it had or was likely to have the effect of substantially lessening competition in the market for goods.

60 NARGA, submission no. 129, p. 45.
61 SSRA, submission no. 150, p. 3.
62 ACCC, public hearing transcript, Canberra, 8 April 2008, p. 129.
63 SSRA, submission no. 230, p. 3.
64 SSRA, submission no. 230, p. 2.
65 Master Grocers Association, submission no. 96, pp. 7–8.
66 Master Grocers Association, submission no. 96, p. 9.
67 Dee Margetts, submission no. 48, pp.1–2.

The former s. 49 also prohibited knowingly inducing or attempting to induce a corporation to engage in illegal price discrimination.

The former s. 49 contained two defences to price discrimination:

> where the discrimination made reasonable allowance for differences in costs of manufacture, distribution, sale or delivery resulting from the differences in places or methods of delivery or quantities in which the goods are supplied to the purchasers

where the discrimination was the result of an act of good faith for the purpose of meeting a price or benefit offered by a competitor.

The former s. 49 was in force between 1974 and 1995. During that time, the Trade Practices Commission (the predecessor of the ACCC) did not institute any proceedings which alleged a contravention of s. 49.

In 1981 the court recognised that conduct in breach of s. 49 may also contravene other provisions of the Act. In *Cool & Sons v O'Brien Glass Industries*, Justice Keely noted the following submission:

> There is some overlapping between the different sub-sections of the Trade Practices Act. In particular, in the present case, it is alleged that the same conduct of the respondent constitutes both exclusive dealing contrary to Section 47 of the Act and price discrimination contrary to Section 49 of the Act. In other words, the giving of a substantial discount on certain conditions can be price discrimination and also, constitute exclusive dealing contrary to Section 47. Indeed, in the applicant's submission, it is the combination of the large systematic discounts and the exclusive dealing condition which greatly increases the adverse anti-competitive effects in the present case …[68]

In that case the Federal Court found breaches of both ss. 47 and 49 of the Act.

In 1993 the Hilmer Committee recommended that s. 49 be repealed.[69] The recommendation echoed concerns of previous inquiries, including the 1976 Swanson review and the 1979 Blunt review. The concern was that s. 49 generally discouraged competitive prices and worked against economically efficient outcomes. The committee concluded that price discrimination generally enhances economic efficiency, except in cases that might be dealt with by ss. 45 or 46 of the Act, and that s. 49 had reduced price competition. The committee accordingly recommended that such a provision be removed from national competition policy. Section 49 was repealed by the *Competition Policy Reform Act 1995* (Cwlth). In the accompanying second reading speech to the Senate for this legislation on 29 March 1995, Senator Crowley stated:

> The prohibition against price discrimination is to be repealed as the provision is largely redundant, and the conduct it is designed to address is adequately covered by other provisions of the Act.

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68 [1981] FCA 95 (13 July 1981).

69 The independent inquiry into a national competition policy, chaired by Professor Frederick Hilmer, was established in October 1992 following agreement by all Australian governments on the need for a national competition policy. The Independent Committee released its *Report by the Independent Committee of Inquiry into a national competition policy for Australia* in August 1993.

19.4.3 ACCC assessment

Price discrimination in grocery retailing

As submitted by the ACCC to the Dawson Review Committee[70] and the 2004 Senate Economics References Committee inquiry into the effectiveness of the Act in protecting small business[71], conduct constituting price discrimination may be anti-competitive or pro-competitive in nature. It will be anti-competitive when it is used to create a barrier to entry to the market or to force competitors from the market. On the other hand, price cutting, even if it is in favour of a large buyer and therefore discriminatory, may be more pro-competitive than anti-competitive. It may engender competition from rival suppliers or in the market generally. As the Swanson Committee observed in 1976, price flexibility is at the heart of competitive behaviour and a general prohibition against price discrimination would substantially limit price flexibility.[72]

While lower prices charged by suppliers to their larger customers may indicate price discrimination, it does not follow that this is necessarily anti-competitive. The ACCC has received submissions that the MSCs pay lower prices for products than other retailers or Metcash. The evidence provided to the inquiry indicated for the most part that such differences in price reflected discounts negotiated on wholesale prices for factors such as volumes purchased and ability to execute promotional support of the supplier's product. The volumes of sales through the MSCs would generally be larger than through Metcash-supplied retailers. Similarly, the vertically integrated MSCs may be better able to execute promotions than Metcash, given that Metcash does not directly control the operation of the retailers it supplies.

Metcash also varies the price at which it sells to the independent retailers that it supplies, based on the volume of product purchased. Given the variety of buying and banner groups supplied by Metcash, differences in prices would be expected. Wider issues about the competitive position of Metcash-supplied retailers (other than related to price discrimination) were discussed in chapter 7.

Price differences can also occur at the retail level, such as between different stores of the one retailer. Chapters 4 and 5 discussed reasons for these price differences, including the level of local competition and demographics. The costs of operating specific stores are also likely to be important, with issues such as freight costs potentially leading to price differences between stores.[73] The ACCC does not consider that there is anything inherently anti-competitive in the notion that stores charge different prices in different areas according to the degree of local competition. In fact, this indicates the importance of local competition on prices paid and that any policy that lowers barriers to entry into supermarket retailing and therefore encourages the establishment of local competition should have positive outcomes for consumers. Similarly, the ACCC does not consider that there is anything inherently anti-competitive in charging more in higher-income demographic areas in comparison to lower-income areas. Prices should be driven by market conditions. The ACCC considers that it is appropriate for an MSC or other retailer to charge different prices in different demographic areas where this is driven by demand and supply conditions. Provided the purpose of the difference in pricing is

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70 In May 2002 the then Treasurer announced the membership and terms of reference of the Committee of Inquiry into the competition provisions of the *Trade Practices Act 1974*, and their administration, the first comprehensive review of Part IV since the Hilmer Committee reported in 1993. The committee was chaired by Sir Daryl Dawson.

71 The Senate Economics References Committee inquiry into *The effectiveness of the* Trade Practices Act 1974 *in protecting small business*, March 2004.

72 In April 1976 the Fraser government established the Trade Practices Act Review Committee (known as the Swanson Committee), parliamentary paper no. 228/1976 is the committee's report to the Minister for Business and Consumer Affairs.

73 For example, ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 52, where Woolworths identified 13 stores, such as Nhulunbuy, where 'exorbitant' freight costs were passed on in higher prices.

not to eliminate a competitor, then the ACCC considers it appropriate that retailers price to meet the competition in a given area.

Price discrimination can also occur where products, which are essentially the same, are labelled differently and sold at different prices within the same store. This form of price discrimination raises the same fundamental issues as other forms of price discrimination. As long as the labelling is not misleading, the ACCC will generally not have a concern with such practices. This is because consumers have different 'willingness to pay' for products, and this form of price discrimination can have potential benefits in allowing end users to obtain goods at more accessible prices.[74] The ACCC has not been presented with evidence that, where price discrimination occurs between products, the cheaper form of such products is unavailable or that consumers are forced to buy the more expensive product. Accordingly it is generally open to consumers to buy the cheaper product. However, retailers may be able to obtain more money from those who are willing and able to pay the higher charge.

Existing provisions of the Act relevant to price discrimination

As noted above, the ACCC considers that price discrimination will often not be anti-competitive. However, it is relevant to consider the instances where anti-competitive price discrimination could contravene the Act.

Interested parties expressed mixed views on the ability of the Act to address anti-competitive price discrimination. The MGA was of the view that there is scope for anti-competitive price discrimination to be addressed under s. 46.[75] In contrast, NARGA submitted that s. 46 is ineffective in catching price discrimination behaviour that results in a substantial lessening of competition.[76] It submitted that the *Boral* case has rendered s. 46 ineffectual as the High Court required that a corporation could later raise prices unilaterally without losing market share for s. 46 to be breached.[77]

Section 46 of the Act does not specifically address price discrimination, but it can prohibit anti-competitive price discrimination. To contravene s. 46, a corporation is required to have substantial market power and must take advantage of its market power for an anti-competitive purpose. However, a corporation needs some degree of market power if it is to successfully implement a price discrimination strategy. If a company has no market power but is able to negotiate a better price from a supplier or chooses to price discriminate between its customers, it is difficult to see why such behaviour should be prohibited. Without market power, the corporation's pricing structure could be undermined by its competitors. Accordingly, the ACCC can see no compelling case for price discrimination per se to be prohibited.

Parties have contented that price discrimination can be a form of predation undertaken with the intention of destroying competitors. Section 46 will capture such conduct if it results from a misuse of market power. This would particularly address situations where, for example, an MSC might lower prices in a particular geographic area served by an independent retailer in an attempt to put that retailer out of business. The ACCC acknowledges NARGA's submission that issues raised by the *Boral* case about the ability to recoup may have restricted the applicability of s. 46 in such cases. The ACCC considers the proposed amendments to s. 46 discussed above about recoupment and predatory pricing may address this issue.

74 This can be illustrated by an example. If a single price for a product is set according to the demand-supply balance, at say $1, then only those consumers who are willing to pay $1 or more for the product will purchase the product. However, if the same product can be sold in one package for 80 cents and in another package for $1.20, then consumers who are willing or able to pay 80 cents for the product are able to make the purchase.

75 Master Grocers Association, submission no. 96, p. 8.

76 NARGA, submission no. 129, p. 45.

77 NARGA, submission no. 129, p. 45.

Sections 45 and 47 of the Act may also have a role in relation to price discrimination arrangements that are alleged to be anti-competitive. Under certain circumstances, pricing arrangements between wholesalers and retailers could amount to an exclusive dealing arrangement under s. 47 or an agreement that substantially lessens competition under s. 45.

In its 2003 report on the competition provisions of the Act, the Dawson Committee recommended no change to the Act on price discrimination and concluded that[78]:

- the effect of price discrimination on competition needs to be assessed on a case-by-case basis
- section 46 of the Act provides an appropriate means to tackle anti-competitive price discrimination, and there is no case for the reintroduction of a prohibition against price discrimination—the principle of like terms for like customers does not of itself offer a suitable basis for regulation in the grocery industry
- there are reasons for differences in prices in the grocery industry that do not involve anti-competitive practices.

The ACCC concurred with the Dawson review findings and continues to hold the view that there is no case for the reintroduction of a specific price discrimination provision.

The ACCC recognises that interested parties have submitted that some overseas jurisdictions have legislative provisions in force, similar to the repealed s. 49, that specifically prohibit anti-competitive price discrimination. While this observation is correct, the ACCC considers that consideration should be given to the development of attitudes towards price discrimination in the US.

Section 49 of the Act was based on the Robinson-Patman Act 1939 (US), which makes price discrimination an offence if it substantially lessens competition, tends to create a monopoly, or injures, destroys or prevents competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them. [79] However, US law acknowledges that price discrimination is generally lawful, particularly where it reflects the different costs of dealing with different buyers or where it results from a seller's attempts to meet a competitor's prices or services.

In commenting on the future of competition policy in the US, the Federal Trade Commission's (FTC) then chairman, Timothy Muris, stated:[80]

> Competition policy succeeds when it serves consumer interests—for example, by pressing producers to offer lower prices or to improve product quality. The true measure of our contribution to the economy is our progress in increasing consumer welfare. Public antitrust enforcement has not always achieved this objective. In some cases, the departure from a consumer-oriented focus resulted from conscious policy choices that equated the well-being of individual firms with consumer interests. From the mid-1930s through the 1960s, enforcement of the Robinson Patman Act was the FTC's foremost antitrust concern. In many instances, the Commission's Robinson-Patman enforcement paid insufficient attention to the effect of the challenged conduct on competition, market efficiency, and consumer welfare. Almost all economists and antitrust lawyers agree that much of that enforcement harmed consumers.

While the Robinson-Patman legislation is still in force in the United States, it has been criticised for being complex, lacking a consumer welfare focus, deterring price competition and promoting price

78 Report by the Dawson Review Committee into the competition provisions of the Trade Practices Act (the Dawson Committee) 2003, *Review of the competition provisions of the Trade Practices Act,* Parliament of the Commonwealth of Australia, Canberra.

79 15 USC §13(a–f).

80 Timothy J Muris, Looking forward: the Federal Trade Commission and the future development of U.S. competition policy, for the Milton Handler Annual Antitrust Review, 10 December, 2002.

uniformity.[81] The ACCC understands that the approach of the FTC has been to use the Robinson-Patman Act less and to now take action against price discrimination under the broader competition law framework (e.g. § 2 of the Sherman Act 1890), and only where the practices involved can be considered to be an attempt to monopolise.[82] The ACCC considers that this is similar to the existing situation in Australia.

Overall ACCC view

At this time the ACCC does not recommend any changes be made to the Act regarding price discrimination, but notes that it has been an issue raised by industry participants. The ACCC considers that there can be significant economic efficiency and competition benefits resulting from price discrimination and is of the view that the various existing provisions of the Act are able to address concerns about anti-competitive price discrimination. Accordingly it does not consider that the re-introduction of the former s. 49, or the amendment of current provisions in the Act, is necessary to address issues of price discrimination.

19.5 Conclusion

The ACCC has considered the submissions above about mergers and acquisitions, predatory pricing and price discrimination. The ACCC recognises that all three issues may have significant ramifications for the grocery retailing industry depending on the context. However, the ACCC considers that these issues do not require laws that specifically apply to the grocery industry.

In relation to mergers and acquisitions, the ACCC maintains its support for a general creeping acquisitions law that would better allow it to address creeping acquisitions more generally. While creeping acquisitions do not currently appear to be a concern in grocery retailing, the ACCC recognises the potential for creeping acquisitions to be an issue in the grocery sector in the future.

Regarding predatory pricing, the ACCC recognises that predatory pricing is a significant concern to a number of interested parties. The ACCC supports the proposed amendments to the existing s. 46 of the Act to better clarify the section's operation and application to circumstances that may constitute predatory pricing. However, the ACCC considers that the specific allegations provided during the inquiry did not appear to constitute predatory pricing.

Regarding price discrimination, the ACCC considers that the existing provisions in the Act are able to address circumstances where anti-competitive price discrimination may occur. It does not consider that there is a need to reintroduce a specific price discrimination law. The ACCC recognises that there can be genuine economic efficiency reasons for price discrimination. No evidence was presented to the inquiry that demonstrated any significant structural problem in the grocery industry that resulted from price discrimination.

81 See for example, Calvani, Terry and Breidenbach, Gilde 'An Introduction to the Robinson-Patman Act and its enforcement by the Government', (1991) 59 *Antitrust Law Journal*, pp. 765, 772; Calvani, 'Effect of current developments on the future of the Robinson-Patman Act', 48 *Antitrust Law Journal*, 1980, pp. 1692, 1695.

82 See, for example, M Briley, 'Price Discrimination under the Robinson-Patman Act', 27 (winter) *University of Toledo Law Review*, 1996, pp. 401, 402.

20 Unit pricing

Key points

- Unit pricing should apply in a consistent manner to standard grocery items sold through significant supermarkets, including Coles, Woolworths, ALDI and large independent stores. Such consistency should extend to product coverage, unit of measure and display characteristics.
- Significant benefits would flow from the mandatory introduction of unit pricing through its promotion of the price searchability of consumers.
- The body responsible for introducing unit pricing should have the flexibility to make binding decisions regarding the precise application of unit pricing.
- A public education campaign should accompany the introduction of unit pricing to ensure that unit pricing has the greatest possible impact.

20.1 Introduction

This section deals with unit pricing—the practice of displaying the price by unit of measure (e.g. per litre or kilogram) along with the total sale price for each item. In those countries where unit pricing is currently in use, the unit price is typically displayed on the same shelf label as the sale price. In the terms of reference for the inquiry the ACCC has been asked to consider 'the representation of grocery prices to consumers'.[1] The ACCC considers that unit pricing is therefore highly relevant to the inquiry.

In Australia the major supermarket chains (MSCs) do not include unit pricing information on packaged grocery items. Products sold by weight are an exception as it is required under state and territory legislation to display unit prices.[2] Examples of products for which there is currently unit pricing include unpackaged fruit and vegetables, meat and deli products. During the inquiry, Coles and Woolworths announced to the ACCC that they intend to introduce unit pricing and both support its mandatory introduction. Woolworths initiated a trial of unit pricing in its Baulkham Hills store in April 2008. ALDI introduced unit pricing in its Australian stores in 2007.

20.2 Overseas experiences

20.2.1 European Union

In 1998 the European Commission (the executive branch of the European Union) adopted the unit prices directive (UPD) which requires traders to indicate both the selling price and the price per unit on all products they offer consumers.[3]

The aim of the UPD is to facilitate price comparison and improve consumer information. It requires the pricing information to be unambiguous, clearly legible and easily identifiable. When advertising mentions a selling price it must include the unit price.

An appraisal of the UPD was completed in August 2004 which covered the implementation by the 15 EU member states (before 1 May 2004). Although most of the EU member states were late in enacting

1 See appendix A.

2 See, for example, Part 4 of the *Trade Measurement Act 1995* (Vic).

3 See http://ec.europa.eu/consumers/cons_int/safe_shop/price_ind/index_en.htm.

the required new legislation, the appraisal found that there was generally good compliance with the UPD and that most enterprises that are legally required to indicate the unit price, do so.[4] With the exception of France, the EU member states adopted lists containing product categories that waived the obligation to indicate unit price. Implementation of the UPD included a derogation for small retail businesses in recognition that the obligation to display unit prices may be an excessive burden for some retailers.

20.2.2 United States

Mandatory provision of unit pricing is required in some states of the US, including New York and Florida. In New York the provisions do not apply to retail stores with annual gross sales of consumer commodities of less than $2.5 million. Florida has enacted the Consumer Unit Pricing Act, which requires mandatory unit pricing. A number of US states refer to the Uniform Unit Pricing Regulation from the National Institute of Standards and Technology, which stipulates that unit prices must be provided unless the package is smaller than one ounce or costs less than $0.50, or there is only one brand in one size on sale at that establishment.

20.2.3 New Zealand

While not currently a legal requirement, unit pricing is common in New Zealand, including in Woolworths stores where it has been displayed for the past few years.

20.3 Submissions

Submissions to the ACCC grocery inquiry that discuss unit pricing have generally supported its introduction. Most submissions that do not support the mandatory introduction of unit pricing do, however, acknowledge that it does provide benefits.

The following section summarises several of the submissions most relevant to unit pricing.

20.3.1 ALDI

ALDI adopted unit pricing in November 2007 and has found that the practice has not resulted in any additional costs for consumers. It also stated that:

> Consumers are often confused when attempting to compare prices between retailers or different sized products. Unit pricing is an effective way of overcoming these difficulties and immediately introduces transparency for consumers helping them make an informed buying decision.[5]

20.3.2 CHOICE (Australian Consumers Association)

CHOICE stated that unit pricing should be introduced into Australian supermarkets as a matter of urgency and believes that there is a lack of transparency on pricing for many basic grocery items. CHOICE stated:

> ... 89 per cent of consumers said they would find comparison product pricing very useful or somewhat useful.[6]

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4 EIM Business and Policy Research, Appraisal of Directive 98/6/EC on consumer protection in the indication of unit prices of products offered to consumers, final report, August 2004.

5 ALDI, submission no. 81, p. 8.

6 CHOICE, submission no. 143, p. 3.

CHOICE noted that unit pricing has the potential to improve price comparability both within a store and between stores, through:

- better price comparability across brands and sizes within a product category at a retail outlet and
- better price comparability across grocery outlets.[7]

CHOICE also believed that it is vital that unit prices are displayed consistently across retailers.

20.3.3 Coles

In its initial submission Coles did not state whether it supported the introduction of unit pricing. It did, however, recognise that the display of unit pricing will improve the information provided to consumers regarding the relative prices of products, but noted that it will also impose additional costs on retailers.[8] Coles also provided the ACCC with a late submission in which it supported the mandatory introduction of unit pricing. Coles' estimates of the costs involved with introducing unit pricing are discussed in a later section.

20.3.4 Consumers Action Law Centre

The CALC submission showed that it is supportive of a national, uniform and compulsory unit pricing system. CALC stated that the important elements of a unit pricing system, such as the format and prominence of display of the unit price, need to have detailed minimum standards set out in legislation. CALC believes that to facilitate price comparisons between stores, unit pricing should also extend to advertising and online purchasing. CALC also believes that consumer education is needed to inform consumers of the benefits of unit pricing.[9]

20.3.5 FoodWorks

FoodWorks supported the practice of displaying unit prices on the grounds that it assists consumers to compare prices. FoodWorks considers that the introduction of unit pricing would represent a competitive advantage, and for that reason would rather see grocery retailers free to choose whether or not to implement it. FoodWorks also stated that the integrated chains have an advantage over independents as they have consistency in their back office IT software.

20.3.6 Metcash

While not directly stating a position on unit pricing, Metcash claimed it would cost independent retailers at least $9.9 million to implement, including:

> Changes to the IT systems used in price calculation and label printing activities (at a cost of ($1.2 million).
>
> A one-off change of all price labels in the store as the labels need to be uniform (i.e. it's unlikely that customers would accept a gradual change of signage in a store to unit prices, so that some products have unit prices and some do not.) This will result in a further labour cost of $8.8 million.

7 ibid., p. 4.

8 ibid., p. 11.

9 CALC, submission no. 124, p. 6.

> Ongoing costs are estimated at around $0.4 million per year, associated with additional data entry for unit pricing requirements.
>
> Even higher costs are likely to eventuate if changes to the shelf label size are required.[10]

Metcash requested that the ACCC undertake a comprehensive cost-benefit analysis before mandating unit pricing.

20.3.7 National Association of Retail Grocers of Australia

NARGA does not believe that the display of unit pricing allows for direct and useful comparison between two products, and submitted that unit pricing is of limited use due to the quality differential between different products. It provided the example of olive oil as a category where price varies with the quality of the product. NARGA stated that unit pricing is irrelevant, and the only valid use of unit pricing is to compare two different sizes of the same brand product.[11] NARGA argued that unit pricing is misleading because it ignores quality differences between products and states that a price conscious consumer is, 'by definition—most likely to choose the cheapest item on the shelf …'.[12]

20.3.8 Queensland Consumers Association

The QCA provided several submissions that call for the introduction of a mandatory unit pricing scheme. It included in its submissions a list of ten minimum requirements for unit pricing:

1. Unit prices must be displayed prominently and clearly on all in-store price signs and be located in close proximity to the product—fonts used must be whichever is the greatest of either a specified percentage of that used to show the selling price or a specified minimum size.
2. Measurements used to indicate unit price must be uniform and easily understood and usable by consumers—applies to products sold by weight, volume etc. and those sold by count/number/item.
3. The same unit of measure must be used for all sizes of the same product.
4. The unit price must be shown even if the unit price and the selling price are identical—i.e. when the package is the same size as the basic unit of measurement.
5. Unit prices must be provided for maximum possible number of grocery products, with minimum exemptions.
6. Unit prices must be shown for products sold on 'special' or other 'promotions' as well as at regular prices.
7. Unit prices must be shown clearly on printed advertisements showing the price of a product sold by measurement.
8. Unit prices must be provided for groceries ordered on the internet as well as those purchased in-store.
9. Minimum standards must be set and monitored regarding accuracy, measurement units used, etc.
10. Initial and on-going consumer education programs must be undertaken.[13]

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10 Metcash, submission no. 181, p. 59.
11 NARGA, submission no. 129, p.50.
12 ibid.
13 QCA, submission no. 38, attachment 2.

20.3.9 Woolworths

Although Woolworths did not comment on unit pricing in its submissions to the inquiry, its CEO Michael Luscombe stated during the public hearing process that Woolworths intends to implement unit pricing, and that it supports its mandatory introduction.[14] Woolworths also provided cost estimates of the introduction of unit pricing which are discussed in section 20.4.

2.3.10 Other submissions

Many other submissions supported the introduction of unit pricing, including:

- The Cancer Council NSW
- Consumers' Association of South Australia
- Dieticians Association of Australia
- Financial Counsellors Association of Queensland
- Population Health Branch, Queensland Health and
- Sydney Food Fairness Alliance.

20.4 Costs and benefits of unit pricing

Proponents of unit pricing have identified a range of benefits that its introduction will deliver to both consumers and the broader grocery sector. Several academic studies have attempted to quantify these benefits, with several studies stating that unit pricing can lead to as much as one per cent saving in expenditure on grocery items.[15] A 2003 study conducted in the United Kingdom (where unit pricing is mandatory) found that over 50 per cent of people frequently use unit pricing, with the figure jumping above 60 per cent for a new product.[16] However, the study also found that 31 per cent of consumers did not understand the benefits of unit pricing, and 35 per cent did not bother to use unit pricing information. Specifically, it identified five main reasons why consumers do not use unit pricing information:

- consumers lack the cognitive ability to make use of unit pricing
- consumers find unit pricing confusing
- the effort required to make comparisons
- consumers are not willing to spend time using unit pricing and
- consumers use other less demanding strategies to get the best value purchases.[17]

By far the main benefit put forward in submissions was that unit pricing will allow consumers to more easily compare prices across different sized products and also across different brands of substitute products.[18] It is claimed that this will lead to a reduction in expenditure on grocery items, especially as many standard groceries items are not sold in sizes that easily lend themselves to comparison.

14 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 101.

15 See, for example, Russo, 'The value of unit pricing', *Journal of Marketing Research*, 1977.

16 V Mitchell, D Lennard and P McGoldrick, 'Consumer awareness, understanding and usage of unit pricing', *British Journal of Management*, vol. 14, 173–87, 2003, p. 177.

17 ibid., p. 179.

18 For example, CALC, submission no. 124.

In its submission to the inquiry, the QCA stated that unit pricing would result in:

> Easier, quicker and more accurate comparison of cost per unit of measure of package sizes within and between brands, between different forms of a product, and between substitute products.[19]

SPAR contended that unit pricing would represent a minimal improvement for consumers and would have little effect on lowering prices. It also stated that implementation costs would include changes to:

- supplier data files
- store data files and
- store labelling/systems.[20]

ACCC's view

Unit pricing assists consumers by improving the pricing information available to them. Consumers often do not have the time, inclination or in some cases the ability to accurately analyse which product has the lowest unit cost in a timely manner. Unit pricing is a tool that would make it easier for consumers to acquire and process pricing information and assist them in engaging in a meaningful price search.[21] There appears to be broad support for unit pricing, with the ACCC's consumer survey finding that 76 per cent of consumers contacted consider that unit pricing would be helpful.[22]

Unit pricing is likely to be highly beneficial as a tool that can increase consumers' understanding of relative prices of substitute products within a store (intra-store comparisons). This would be the case particularly for those products that have multiple product sizes, such as Vegemite, which is sold in the following quantities: 145, 150, 220, 400 and 600 grams.

Furthermore, manufacturers will from time to time change packet sizes. For example, the 600 gram Vegemite was introduced in September 2007, shortly after the deletion of the 910 gram size.[23] Unit pricing will assist consumers in deciding whether the new pack size is a more cost effective purchase. Even for products where a per kilo/litre comparison may be fairly easy for many consumers, for instance, comparing the price between a 500 gram pack and a one kilo pack, unit pricing can still be beneficial to the consumer as it highlights the relative per unit prices of the two products.

Unit pricing is also useful in comparing prices across other brands using different sized packs; however, clearly consumers will also have to make their own judgment on whether the quality of the different brands justifies any price differential. In its submission, NARGA stated that unit pricing is misleading as it does not account for the differences in quality between products.[24] However, the ACCC considers that consumers are faced with the task of determining the difference in quality of products with or without unit pricing. The fact that quality varies across brands does not reduce the value of the information provided to consumers in the display of unit pricing.

Unit pricing is likely to provide some assistance to consumers in comparing prices between retailers (inter-store comparisons). Consumers may be more likely to remember a single unit price of a product (e.g. when shopping at a different store and comparing prices) than when they have to remember both the size and the price of an item.

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19 QCA, submission no. 38, p. 21.

20 SPAR, submission no. 195, p. 7.

21 R Smith, 'The Australian grocery industry: a competitive perspective', *Australian Journal of Agricultural and Resource Economics*, 2006, p. 48.

22 ACCC, Survey of grocery consumers, April 2008.

23 Kraft, email to ACCC, 6 June 2008.

24 NARGA, submission no. 195, ch. 14.

Unit pricing in catalogues and in other forms of advertising would also assist inter-store price comparisons. The results of the ACCC's consumer survey indicate that the inclusion of unit pricing in advertising would likely improve the quality of price information available to consumers. The survey found that 77 per cent of those people who consider price an important factor when choosing where they shop do in fact compare prices advertised in brochures and letter drops.[25]

The implementation of unit pricing would involve several distinct costs to retailers including updating IT systems and labour costs. Both Coles and Woolworths have informed the ACCC that costs associated with unit pricing would decrease as the implementation period was lengthened. Metcash's submission to the inquiry provided a high level estimate of these costs, stating that the implementation cost to independent retailers would be at least $9.9 million, incorporating $1.2 million for changes to the IT systems and $8.8 million in labour costs for a one-off change to all in-store price labels.[26] Metcash did not comment on how it believes this cost would change if a longer timeframe for implementation was allowed.

Woolworths CEO, Michael Luscombe, said during the inquiry's public hearing that Woolworths anticipates the cost of implementing unit pricing to be about $4 million.[27] Mr Luscombe said this cost would depend on the timeframe that was permitted for the introduction, and that it would not represent any additional cost if Woolworths was given a 12-month period to implement unit pricing. Mr Luscombe stressed that if Woolworths were required to change its 'shelf stripping' to accommodate mandated font size, the capital cost would be around $6 million to $7 million.[28] Coles estimates the costs of introduction would be $20 million if immediate implementation were required, decreasing to between $5 million and $10 million if a 12- to 18-month timeframe was allowed.[29] It is unclear why there is such a large discrepancy between the cost estimates of Coles and Woolworths.

The main costs identified in implementing unit pricing are:

- IT
- labour
- printing new price tickets and
- changing shelf stripping (if required to accommodate a mandated size label).

From the evidence provided it appears that costs will be higher if unit pricing was to be implemented in a shorter timeframe, as a greater number of shelf labels would all have to be replaced solely for the purpose of implementing unit pricing. If unit pricing could be implemented over a longer timeframe, then the old shelf labels would simply be replaced over time with the unit pricing shelf labels in the normal course of business.

The ACCC notes the divergence in cost estimates provided by several parties. However, the ACCC is not in a position to provide either a robust estimate of these costs or estimate how the likely costs may change relative to the time period allowed for implementation.

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25 ACCC, Survey of grocery consumers, April 2008.

26 Metcash, submission no. 181, p. 58.

27 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 101.

28 ibid.

29 Coles, submission no. 225, p. 10.

20.5 Should unit pricing be voluntary or mandatory?

Several submissions address the issue of whether unit pricing should be introduced on a mandatory basis or left to individual retailers to implement voluntarily. As noted above, ALDI has already implemented unit pricing, and during the course of the inquiry Coles and Woolworths have announced their intention to implement unit pricing.

The ACCC received several submissions that opposed the introduction of unit pricing on a mandatory basis. Many of the submissions opposed to unit pricing did recognise that it could benefit consumers, but stated that the greatest benefit would be achieved in a non-regulated setting where unit pricing could be used as a competitive advantage.[30]

In its initial submission to the inquiry, Coles did not state a preference for or against the introduction of unit pricing, but submitted that while price is important to consumers, many other factors were taken into account at the point of purchase. To this end Coles submitted that:

> Competitive pressure will continue to ensure innovative and different approaches to marketing to customers that will deliver more benefit to customers than any mandated approach to unit pricing.[31]

Coles also outlined some of the 'significant practical challenges' that would result from a mandated approach to unit pricing, including:

> Difficulties with definition, different technology platforms and different approaches to marketing and innovation consistent with competing brand propositions.[32]

However, Coles stated during the ACCC public hearing that it would prefer to see unit pricing adopted universally by all supermarkets and food retailers across Australia.[33] In expressing his support for the mandatory introduction of unit pricing, Coles COO, Mick McMahon, stated that, 'we would prefer to see [unit pricing] for all retailers … because otherwise it adds costs for some and not for others …'.[34] Coles also expressed a concern about double spending if it introduced unit pricing on a voluntary basis; only to later have a different, mandatory standard imposed requiring further expenditure.

In support of a mandatory unit pricing scheme, Coles stated in its supplementary submission that:

> Unit pricing will benefit customers if the practice is adopted universally by all supermarket retailers across Australia. If unit pricing is limited to a few retailers, or is introduced other than in a uniform manner, a scheme could result in more confusion for consumers than it would benefit.[35]

Although Woolworths did not comment on unit pricing in its submission to the inquiry, its CEO, Michael Luscombe, stated during the public hearing process that Woolworths intends to implement unit pricing, and that it supports its mandatory introduction.[36]

The QCA argued that it is critical to introduce unit pricing on a mandatory basis. It provided examples from overseas, claiming that when unit pricing was introduced by retailers on an ad hoc basis the benefits to consumers have been lower and in some cases the costs to business higher.[37] The QCA submitted that the rationale for mandatory introduction is to ensure that all consumers have access to

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30 See, for example, FoodWorks submission no. 90, p. 22; and George Weston Foods Limited, submission no. 138, p. 5.

31 Coles, submission no.225, p. 11.

32 ibid.

33 ACCC, public hearing transcript, Melbourne, 26 May 2008, p. 5.

34 ibid., p. 65.

35 Coles, submission no. 225, p. 10.

36 ACCC, public hearing transcript, Melbourne, 19 May 2008, p. 101.

37 QCA, submission no. 38, p. 7.

unit pricing, and that it is displayed in a consistent manner across retailers.[38] It identified the following advantages of an early and compulsory introduction rather than voluntary take up:

- unit pricing will be provided more widely and quicker
- there will be less across-store variation in the system provided, and compliance can be monitored
- the government is more likely to fund consumer awareness campaigns
- implementation costs are likely to be lower, especially if numerous voluntary systems are established which require significant modification to comply with subsequent compulsory systems.[39]

ACCC's view

The ACCC considers that a voluntary unit pricing regime is unlikely to be as beneficial to consumers as a mandatory regime.

In a competitive environment, if unit pricing is seen by consumers as beneficial, then retail stores that wish to compete effectively will introduce unit pricing and their competitors are likely to feel pressure to follow. However, without a mandatory system, implementation is likely to be ad hoc and inconsistent between stores. Given that both Coles and Woolworths have committed to the introduction of unit pricing and the Queensland Government has announced its intention to introduce the practice in September 2008, the ACCC notes there is a risk that achieving consistency may come at a price. If retailers are required to comply with a state-based scheme, or have already introduced unit pricing voluntarily, only to have to adapt to a national scheme at a later stage, the compliance costs will be greater if there are inconsistencies between the two schemes.

Differences in the approach to unit pricing between stores may mislead consumers (for example, some stores may unit price certain products on a per kilo basis, and others on a per 100 gram basis). Furthermore, retail chains may selectively choose to use unit pricing only for those products showing them to be competitive. Those retailers not required to display unit pricing, but that choose to do so on a voluntary basis, must be required to adhere to the mandatory standards.

The ACCC also considers that retailers need certainty regarding any possible obligations relating to unit pricing as soon as possible. An outcome where the MSCs introduce unit pricing in a particular style, which then must be changed to meet mandated requirements, would be inefficient and incur greater costs. This inefficiency would also occur if unit pricing was introduced on a state/territory basis, as those retailers who operate across several states would have the burden of complying with several, possibly inconsistent state/territory based regimes.

20.6 Implementation issues

If unit pricing was to be introduced, the ACCC recognises that there are several issues that need to be considered more fully before implementation. In particular, there are several methods by which unit pricing could be introduced on either a voluntary or mandatory basis, including:

- amendment to the current state and territory trade measurement legislation
- inclusion in the proposed national trade measurement legislation which is set to replace the state and territory legislation from 1 July 2010

38 ibid.

39 ibid.

- inclusion in stand-alone consumer legislation, linked to the Trade Measurement Act and
- a voluntary or mandatory industry code under s. 51AE of the Trade Practices Act.

Currently, trade measurement legislation is the responsibility of the states and territories that have enacted uniform legislation. However, in April 2007 the Council of Australian Governments (COAG) formally agreed that the federal government should assume responsibility for trade measurement; and in December 2007 the National Measurement Institute issued a discussion paper on this transitional process.[40] The QCA recommended in its submission to the inquiry that a mandatory unit pricing scheme should be based in this new federal trade measurement legislation.

The ACCC considers it is important to ensure that appropriate legislative mechanisms are implemented to ensure that a mandatory unit pricing regime is nationally consistent. These mechanisms should also be sufficiently flexible to enable:

- the agency responsible for the regime to issue legislative instruments which clearly delineate which stores and products are and are not included in the unit pricing regime; and
- to allow for appropriate compliance monitoring and enforcement.

Timeframe for implementation

If grocery retailers were required to implement unit pricing, consideration would have to be given to the timeframe for which the implementation was allowed. As stated earlier, both Coles and Woolworths indicated that they believe the implementation cost would be significantly higher if retailers were required to implement unit pricing in a short timeframe. The ACCC understands that a rapid compulsory implementation may impose greater costs on many retailers; however, a gradual and protracted introduction may have lower benefits if it leads to confusion and a lower take-up of unit pricing information.

20.6.1 Application of unit pricing

Stores

In defining which grocery stores would be required to display unit pricing, the key question appears to be to what extent smaller operators should be included, and on what basis should coverage be determined? There are several options available to determine the application of unit pricing. One possible way is to only introduce it into stores above a certain size or above a certain turnover. While consumer benefits would increase with wider coverage, smaller operators may face a much higher cost relative to turnover than larger stores. Operators with several stores may also receive the benefit of economies of scale.

The ACCC considers that the unit pricing regime apply to all significant supermarkets, including but not limited to Coles, Woolworths, ALDI and large independent stores. As the majority of grocery sales are purchased in large format stores, this would ensure that unit pricing information was available to consumers at the time the majority of groceries were purchased.

The incremental benefits of unit pricing are likely to decrease as store size decreases due to the smaller range of substitute products in small stores. Further, smaller stores will face higher implementation costs relative to turnover compared to larger stores. Therefore the ACCC considers that before unit

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40 The National Measurement Institute is established under the *National Measurement Act 1960* (Cwlth) and is responsible for the coordination of Australia's national measurement system. The discussion paper can be found at www.measurement.gov.au.

pricing is introduced a detailed cost-benefit analysis should be undertaken to determine which stores unit pricing should apply to.

It is also important that the administrative body has discretion to exempt certain stores in specific circumstances.

If consumers value unit pricing information, it is likely that it would be viewed by retailers as a competitive advantage and other stores may want to implement it. Therefore smaller stores should be allowed to introduce unit pricing on a voluntary basis, provided they complied with the legislative standards.

Products

It is also necessary to define what products unit pricing applies to. The ACCC considers the aim should be to ensure that unit prices are displayed on as many standard grocery items as possible. However, there may be isolated instances where it is not practical to display unit pricing and for this reason it is essential that the administrative body has the authority to exempt certain products where unit pricing is deemed inappropriate.

20.6.2 Unit of measure

The QCA identified consistency in the unit of measurement as one of the most important elements of a unit pricing scheme, and stated that prices should be displayed either per kilo, litre, metre, square metre, cubic metre, or per item for products sold by count.[41] While the ACCC considers that consistency is paramount, the most appropriate unit of measure may vary depending on the product, and the responsible body should have the discretion to define what unit of measure would apply in particular circumstances.

20.6.3 Education

CALC states that 'to best achieve its objectives, a unit pricing system should be accompanied by a consumer education strategy'.[42] Several other parties, including the QCA, submit that an educational program is essential for unit pricing to be most effective.[43] UK studies also support the need for targeted education campaigns to ensure that the maximum number of consumers understand and make use of the unit pricing information.[44] The ACCC considers that an education campaign is likely to be useful in assisting consumers to take advantage of unit pricing information and ensuring that its benefits are fully realised.

20.7 ACCC's conclusion—unit pricing

The ACCC concludes that significant benefits to consumers would flow from the mandatory introduction of unit pricing, but recognises that a number of implementation costs would result. Accordingly, while the ACCC expects that the benefits to consumers would be likely to outweigh costs, it would be prudent for a detailed cost benefit analysis to be undertaken to examine practical implementation issues with a view to minimising the costs of introduction.

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41 QCA, submission 38, p. 33.

42 CALC, submission no. 124, p. 9.

43 QCA, submission no. 38, p. 33.

44 V Mitchell, D Lennard and P McGoldrick, 'Consumer awareness, understanding and usage of unit pricing', *British Journal of Management*, vol. 14, 173–87 (2003) at 177.

20.8 ACCC's recommendation—unit pricing

- The ACCC recommends that a mandatory, nationally-consistent unit pricing regime be introduced for standard grocery items both on in-store price labels and in print advertising. The ACCC recommends that the unit pricing regime apply to significant supermarkets, including Coles, Woolworths, ALDI and large independent stores. Smaller stores will face higher implementation costs relative to turnover compared to larger stores. The ACCC therefore considers that before unit pricing is introduced a detailed cost-benefit analysis should be undertaken to determine which stores unit pricing should apply to.[45] Grocery outlets not required to comply with the unit pricing regime should be allowed to display unit prices on a voluntary basis. If they choose to do so, they should be required to comply with the mandatory requirements.
- The ACCC has heard evidence that implementation costs will vary depending on the time allowed for implementation. The ACCC considers that a six- to 12-month implementation period will sufficiently reduce costs, while ensuring that unit pricing is implemented in a timely manner. The ACCC recommends that the relevant administrative body or Australian Government, consult with industry participants and examine how cost varies depending on the implementation timeframe.
- The ACCC recommends that any legislative mechanisms implemented should also be sufficiently flexible to enable the agency responsible for the regime to issue legislative instruments which clearly delineate which stores and products are and are not included in the unit pricing regime and allow for appropriate compliance monitoring and enforcement.
- The ACCC also recommends that a public education campaign be established to ensure that unit pricing is fully understood by consumers and has the greatest possible impact.

45 Further, an assessment of the extent to which unit pricing should apply to non-print advertising and internet retailers that do not have a physical retail store should be conducted.